June 3, 2011

VIA ELECTRONIC DELIVERY

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

RE: *Position Limits for Derivatives*, RIN 3038–AD15 and 3038–AD16

Dear Mr. Stawick:

I. INTRODUCTION

BG Americas & Global LNG ("BGA") respectfully submits these comments in response to the request for public comment in the release issued by the Commodity Futures Trading Commission (the "CFTC" or "Commission") in *Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, which was published in the *Federal Register* on May 4, 2011. The release reopens and extends the comment period of many of the CFTC's proposed rulemakings until June 3, 2011.[1] Specifically, the comments provided herein below address concerns with the *bona fide* hedging exemption as set forth in the Commission's Notice of Proposed Rulemaking, *Position Limits for Derivatives*.[2]

BGA is a business unit of the BG Group plc ("BG Group"), a global natural gas company based in the United Kingdom and a major producer and supplier of natural gas in the United States. BGA is responsible for all of BG Group's operations in North and South America, the Caribbean, the company's global marine operations and its global liquefied natural gas ("LNG") operations.

1 *Reopening and Extension of Comment Periods for Rulemaking Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 76 Fed. Reg. 25,274 (May 4, 2011); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010) ("Dodd-Frank").

2 *Position Limits for Derivatives,* Notice of Proposed Rulemaking, 76 Fed. Reg. 4752 (Jan. 26, 2011) (the "*Proposed Rule*").

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BG Group owns natural gas producing assets in Louisiana and Texas known as the Haynesville Shale and in Pennsylvania and West Virginia known as the Marcellus Shale. BG Group is one of the largest suppliers of LNG to the U.S. and owns import capacity rights at Southern Union Company's Lake Charles, Louisiana ("Lake Charles") and El Paso Corporation's Elba Island, Georgia import terminals. BG Group also has an interest in associated liquids that are extracted from imported LNG at the Lake Charles LNG import terminal. BG Group's subsidiary, BG Energy Merchants, LLC ("BGEM"), is a major marketer of natural gas and electricity throughout the U.S., natural gas liquids in the isolated market between Texas and Mississippi, and oil produced by BG Group in offshore Brazil to worldwide markets. BGEM regularly engages in swaps to hedge the commercial risk associated with BG Group's production and marketing activities relating to its natural gas, liquids and oil businesses.

II. Executive Summary

These supplemental comments highlight several flaws in the proposed definition of a *bona fide* hedging transaction set forth in proposed CFTC Rule 151.5(a) which, if adopted as proposed, will disrupt the efficient operation of, and adversely impact liquidity in, physical markets for exempt commodity markets. As discussed in Section III, in failing to provide a vehicle for commercial firms, such as BGEM, to apply for, and receive, an exemption from speculative position limits for "non-enumerated hedges," the Commission, contrary to the intent of Congress, has eliminated several important classes of transactions from the definition of a *bona fide* hedging transaction that are routinely undertaken in physical commodity markets to hedge or mitigate commercial risk.

In this regard, the proposed definition of *bona fide* hedging transaction simply does not reflect the hedging practices generally used in physical commodity markets, notably energy markets. Specifically, to qualify for a *bona fide* hedging exemption, the *Proposed Rule* appears to require market participants to match on a one-to-one basis a swap transaction to a specific physical transaction. Participants in energy commodity markets, however, frequently enter into swaps and futures to dynamically hedge underlying physical assets on a portfolio (*i.e.,* aggregate) basis. BGA respectfully submits that any final rule adopted by the Commission in this proceeding must preserve the ability of commercial firms to effectively and efficiently hedge their commercial risk exposure.

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III. SUPPLEMENT COMMENTS

BGA highlights specific flaws in the proposed definition of a *bona fide* hedging transaction that threaten its utility for commercial firms transacting in physical commodity markets and respectfully requests that the Commission address each identified issue to ensure that any final rule in this proceeding will be clearer and commercially practicable.

A. THE ELIMINATION OF "NON-ENUMERATED" HEDGES IS NOT SUPPORTED BY ANY LEGAL BASIS OR LEGITIMATE POLICY RATIONALE

As argued by BGA in its initial comments submitted in this proceeding, the *Proposed Rule*, without much explanation, excludes from new CFTC Rule 151.5(a) provisions that would define "non-enumerated hedges" or provide a vehicle for a Commercial Entity to apply for, and receive, an exemption from speculative position limits for "non-enumerated hedges."[3] In contrast, the *Proposed Rule* provides that the only transactions or positions that would be recognized as *bona fide* hedges would be those described under new CFTC Rule 151.5(a)(2) as "enumerated hedges." Specifically, the proposed rule states, in relevant part:

> "[N]o transactions or positions shall be classified as *bona fide* hedging for purposes of § 151.4 unless . . . the provisions of paragraph (a)(2) of this section have been satisfied."[4]

In proposing to adopt this provision (hereinafter referred to as the "Enumerated Hedges Only" provision), the Commission has eviscerated the general definition of *bona fide* hedging transactions or positions as set forth in proposed CFTC Rule 151.5(a)(1), which came directly from CEA Section 4a(c)(2), as amended by Dodd-Frank. Significantly, the Commission has effectively eliminated from the *bona fide* hedging definition numerous classes of transactions that Congress intended to include.

It is neither in the public interest nor is it in the Commission's interest as a market regulator to structure a rule that eliminates its flexibility to allow hedge exemptions based on "non-enumerated hedging transactions." Markets are dynamic.

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[3] *See* Comments of BG Americas and Global LNG, *Position Limits for Derivatives*, Notice of Proposed Rulemaking (Mar. 28, 2011). The analogs in existing Commission regulations are Sections 1.3(z)(3) and 1.47. Under the *Proposed Rule*, Section 1.3(z) would not apply to speculative position limits for exempt and agricultural commodities and Section 1.47 would be deleted altogether.

[4] Proposed CFTC Rule 151.5(a)(1).

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Many of the proposed rules being implemented by the Commission pursuant to Dodd-Frank, particularly this *Proposed Rule*, could have the unintended consequence of severely diminishing liquidity in certain markets. To avoid this result, the Commission should preserve its ability to allow exemptions based upon non-enumerated transactions.[5]

Accordingly, in order to ensure consistency with the statutory language of new CEA Section 4a(c) and avoid harmful impacts to agriculture and exempt commodity markets, BGA recommends that the Commission (i) strike the last clause in proposed CFTC Rule 151.5(a)(1)(iv)(B)—"and the provisions of paragraph (a)(2) of this section have been satisfied;" and (ii) revise the lead-in language of proposed CFTC Rule 151.5(a)(2) to add following the word "includes" the phrase ", but is not limited to,".[6]

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[5] This does not mean that the Commission is compelled to grant exemptions—it will retain its discretion on a case-by-case basis based on the market's ability to support it, among other things. What it does mean, however, is that if the Commission believes an exemption may be warranted to add liquidity to a particular market at a particular time it would not be forced to promulgate an amendment to Part 151.5 in order to do so.

[6] BGA supports the following revisions proposed by the Working Group of Commercial Energy Firms in comments individually filed with the Commission in the above-referenced proceeding on March 28, 2011:

§ 151.5 Exemptions for referenced contracts.

(a) *Bona fide hedging transactions or positions.*

(1) Any trader that complies with the requirements of this section may exceed the position limits set forth in § 151.4 to the extent that a transaction or position in a referenced contract:

. . . .

(iv) Reduces risks attendant to a position resulting from a swap that—

. . . .

(B) Meets the requirements of paragraphs (a)(1)(i) through (a)(1)(iii) of this section. Notwithstanding the foregoing, no transactions or positions shall be classified as *bona fide* hedging for purposes of § 151.4 unless such transactions or positions are established and liquidated in an orderly manner in accordance with sound commercial practices~~ and the provisions of paragraph (a)(2) of this section have been satisfied~~.

(2) *Enumerated Hedging Transactions.* The definition of bona fide hedging transactions and positions in paragraph (a)(1) of this section includes**, but is not limited to,** the following specific transactions and positions: . . . .

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The following discussion supports the recommendation to revise the proposed language of the *bona fide* hedging transaction definition set forth in new CFTC Rule 151.5(a).

1. ROUTINE COMMERCIAL HEDGES THAT WOULD NOT QUALIFY AS A BONA FIDE HEDGING TRANSACTION UNDER THE PROPOSED POSITION LIMITS RULE

a. ASSETS THAT A PERSON ANTICIPATES OWNING OR MERCHANDISING

Proposed CFTC Rule 151.5(a)(1) includes as a *bona fide* hedge the anticipated ownership, production, manufacture, processing, or merchandising of an exempt or agricultural commodity.[7] Yet proposed CFTC Rule 151.5(a)(2), which sets forth "Enumerated Hedging Transactions," does not contain a parallel provision. Indeed, only "unsold anticipated production"[8] and "unfilled anticipated requirements," including requirements for "processing, manufacturing, and feeding"[9] qualify as enumerated hedges. Thus, as a result of the Enumerated Hedges Only provision, certain transactions entered into to hedge anticipated ownership or merchandising of an exempt or agricultural commodity would not qualify as *bona fide* hedging transactions under the *Proposed Rule*.[10]

BGA also notes the variance in the treatment of marketing or merchandising activities and the treatment of producers or processors in the *Proposed Rule* is remarkably similar to the differential treatment of cash market "trading" positions provided in (i) footnote 23 of the proposed rule implementing the end-user exception from mandatory clearing, and (ii) footnote 128 of the proposed rule further defining the term Major Swap Participant (collectively, the "Footnotes").[11] BGA is addressing these

[7] *See* analogous new CEA Section 4a(c)(2).

[8] Proposed CFTC Rule 151.5(a)(2)(i)(B).

[9] Proposed CFTC Rule 151.5(a)(2)(ii)(C).

[10] To the extent that language in the enumerated hedging section of the proposal parallels language in the enumerated hedging section of current Rule 1.3(z), the impact is different as a result of the elimination of the availability of an exemption for non-enumerated hedges.

[11] *End-User Exception to Mandatory Clearing of Swaps,* Notice of Proposed Rulemaking, 75 Fed. Reg. 80,747 (Dec. 23, 2010) ("Proposed End-User Exception Rule"); *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant,"* 75 Fed. Reg. 80,174 (Dec. 21, 2010).

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specific concerns in separately filed supplemental comments in the relevant proceedings. In short, based on interpretive guidance in the Footnotes, the Commission without a sound legal or policy rationale appears to be taking the position that a marketer or merchandiser that acquired a commodity for resale (*i.e.*, a cash market "trading" position) would not be entitled to treat a hedge of that position as "mitigating or reducing commercial risk" in order to avail itself of the end-user exception or certain calculations in connection with the definition of Major Swap Participant.

As in the instant proceeding, such differential treatment in those proposed rules would effectively eliminate "merchant,"[12] "merchandiser,"[13] or "middlemen"[14] from the litany of commercial parties historically recognized as part of the chain from the production to the consumption of commodities. These commercial market participants own physical commodities and bear significant price risk as a result. This result is contrary to the CEA and that the use of derivatives by these firms to hedge that risk should qualify as *bona fide* hedges and as "hedging and mitigating commercial risk" under the Commission's rules.

b. HEDGES OF SERVICES

Proposed CFTC Rule 151.5(a)(1) would include as a *bona fide* hedging transaction "services that a person provides or purchases, or anticipates providing or purchasing."[15] However, proposed CFTC Rule 151.5(a)(2), which sets forth Enumerated Hedging Transactions, does not contain a parallel provision. Thus, under the Enumerated Hedges Only provision, hedges of the potential change in value of services would not constitute as *bona fide* hedging under the Commission's proposal.

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[12] *See* 17 C.F.R. § 32.4(a) (2010) ("a producer, processor, or commercial user of, or a merchant handling, the commodity" may be an offeree of an option under the trade option exemption) (emphasis added).

[13] *Exemption for Certain Contracts Involving Energy Products*, 58 Fed. Reg. 21,286 (Apr. 20, 1993) (granting exemptive relief in response to an application filed by a group of entities which represented that each was a producer, processor and/or merchandiser of crude oil, natural gas and/or crude oil and natural gas products, or was otherwise engaged in a commercial business in these commodities).

[14] *See* Section 4a(c) of the CEA ("producers, purchasers, sellers, middlemen, and users of a commodity or product derived therefrom" should be eligible for hedge exemptions) (emphasis added).

[15] *See* analogous new CEA Section 4a(c)(2).

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c. Spreads and Arbitrage Positions

Section 4a(a) of the CEA both before and after the passage of Dodd-Frank authorizes the Commission to "exempt[] transactions normally known to the trade as 'spreads' or 'straddles' or 'arbitrage' or from fixing limits applying to such transactions or positions different from limits fixed for other transactions or positions." Under the regimes for speculative position limits currently administered by both NYMEX and the IntercontinentalExchange ("ICE"), exemptions from speculative position limits are available for arbitrage, intra-commodity spread, inter-commodity spread, and eligible option/option or option/futures spread positions.[16] Under the *Proposed Rule*, these classes of transactions would not qualify for an exemption.

Arbitrage and spread positions create a limited risk of causing sudden or unreasonable fluctuations or unwarranted changes in the price of a commodity. In fact, they are universally recognized as transactions that limit unwarranted changes in price by tying the price of one instrument to another, creating a market efficiency that reduces the risk of aberrational pricing. There has never been an issue of sudden or unreasonable fluctuations or unwarranted changes in price in exempt commodity markets attributable to arbitrage or spread positions that would justify the elimination of exemptions for such transactions at this time.

Given the fact that these positions currently exist in the market and may be the basis for an exemption from limits on both NYMEX and ICE, the Commission should consider the potential negative impact on liquidity if such positions were no longer to be permitted such treatment.[17] In this regard, the Commission should permit exemptions

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[16] *See* NYMEX Rule 559.C and *ICE OTC Regulatory Rulebook for Significant Price Discovery Contracts, Rule* 1.17 ("ICE OTC Rule 1.17").

[17] The following illustrates BGA's concerns. Company A owns a gas-fired generation plant which it sells on a "merchant" (*i.e.,* uncommitted) basis into organized wholesale electricity markets. Company A is good at operating power plants, but is not good at managing the price risk associated with procuring gas and selling the power at market or with scheduling gas and power. Company A wants to transfer the physical logistics risk and the price risk to Company B, so Company A enters into a physical tolling arrangement with Company B, who buys the physical gas at price $X, converts it to power and sells the physical power at market price $Y.

Company B is managing physical commodity/logistics and price risk, without owning the asset. Thus, it is necessary to hedge the price risk exposure that has been transferred to Company B, which it will likely hedge through swap transactions. Although swaps used to hedge the value of the spread fall within the definition of *bona fide* hedge under Section 737 of Dodd-Frank and seemingly under proposed CFTC Rule 151.5(a)(1), they would not be treated as such because there is no provision for these types of transactions in the "enumerated hedges" provision set forth in new CFTC Rule 151.5(a)(2).

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from position limits for transactions such as spreads or arbitrage, as provided for under CEA Section 4a(a).

d. Cross-Commodity Hedges

Proposed CFTC Rule 151.5(a)(2)(v) would permit cross-commodity hedges "provided that the positions shall not be maintained during the five last trading days of any referenced contract." This would result in certain cross-commodity transactions being excluded from treatment as a *bona fide* hedging transaction.

e. Unfixed price commitments

i. In the Same Calendar Month

New CFTC Rule 151.5(a)(2)(iii) would permit a hedge of offsetting unfixed price purchase and sale commitments only if they were basis different delivery months. Commercial energy firms often need to hedge basis risk in the same delivery month, but a different delivery location. Under new CFTC Rule 151.5(a)(2)(iii), purchases and sales occurring in the same deliver month would not qualify as a *bona fide* hedge.

ii. In the same commodity

New CFTC Rule 151.5(a)(2)(iii) would permit a hedge of offsetting unfixed price purchase and sale commitments only if they were in the same commodity. However, commercial energy firms at times need to hedge basis risk between two different commodities. Under this rule, transactions which reference prices for different commodities would not qualify as a *bona fide* hedging transaction.

f. Hedging in the last five days of trading an expiring contract

i. Unsold anticipated production

If adopted as proposed, new CFTC Rule 151.5(a)(2)(i)(B) will have adverse and uneconomic consequences in commercial markets as it prohibits market participants from holding *bona fide* hedging positions relating to unsold anticipated production in the last five days of trading. In order to maintain a *bona fide* hedge position for the unsold anticipated production, market participants will be required to roll their existing hedges

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into the next month and, in doing so, take on basis risk for the month/month spread for the last five trading days of the month.

ii. NON-FIXED PRICE CONTRACTS

The same concern applies under new CFTC Rule 151.5(a)(2)(iii) which effectively prohibits this position market participants from holding *bona fide* hedge position into the last five trading days of the month for contracts non-fixed price contracts (*i.e.,* contracts with indexed pricing terms). As a result, market participants that wish to maintain a *bona fide* hedge during the last five trading days of a month will be forced to roll their positions into the next month, thus, taking on basis risk associated with the month/month spread during this period.

B. THE *PROPOSED RULE* TREATS BONA FIDE HEDGES IN AN INCONSISTENT MANNER

In addition to the concerns addressed in Section III.A, the purpose and effect of the distinction presented in proposed CFTC Rule 151.5(a)(2) is unclear. Specifically, the lead-in language to proposed subpart 151.5(a)(2)(ii) states that "purchases of *referenced contracts*" may qualify as *bona fide* hedges provided certain conditions are met. In contrast, the lead-in language to proposed subpart 151.5(a)(2)(i) states that "sales of *any commodity underlying referenced contracts*" may qualify as *bona fide* hedges provided the right conditions are met. Nowhere in the *Proposed Rule* does the Commission explain the purpose behind this distinction.

Under the analogous provisions of Section 1.3(z) of the Commission's current regulations,[18] purchases and sales are treated equally—that is, purchases or sales of futures contracts (and not the underlying commodity) may qualify as *bona fide* hedging transactions. Thus, it appears that the phrase "any commodity underlying" ought not to be included in proposed CFTC Rule 151.5(a)(2). BGA reiterates its prior request that the Commission either (i) harmonize the two provisions in the *Proposed Rule*, or (ii) clarify the intent and purpose behind the distinction should the Commission adopt such language.

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[18] 17 C.F.R. § 1.3(z).

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C. THE PROPOSED FRAMEWORK FOR *BONA FIDE* HEDGE EXEMPTIONS SHOULD REFLECT THE HEDGING PRACTICES OF COMMODITY MARKETS

The Commission also should recognize that, although market participants in physical energy commodity markets use swaps and futures to hedge underlying physical positions, they frequently do not execute such transactions specifically for the purpose of hedging a specified underlying physical position (*i.e.,* on a one-for-one basis). Prudent risk management practices generally involve dynamically hedging underlying physical assets and related positions on a portfolio basis.[19]

In light of the foregoing, BGA respectfully submits that concept of *bona fide* hedging should include all hedging activity that maximizes the value of the asset. The adoption of a prescriptive one-to-one matching requirement of each swap to a specific physical transaction or an asset position is inconsistent with the hedging practices of many participants in commodity markets, particularly energy markets, and is thus unnecessary and overly burdensome. As such, BGA requests that the Commission modify its hedge exemptions and related reporting requirements to reflect more appropriately the actual hedging practices of participants in energy markets in any final rule it adopts in this proceeding.

[19] In the CFTC's proposed rule on the end-user exception from mandatory clearing, the Commission recognizes that whether a position is used to hedge or mitigate commercial risk should be determined by the facts and circumstances at the time the swap is entered into, and should take into account the person's overall hedging and risk mitigation strategies. *See* Proposed End-User Exception Rule, at 80,753. In relevant part, the Proposed End-User Exception Rule states:

> As a general matter, the Commission preliminarily believes that whether a position is used to hedge or mitigate commercial risk should be determined by the facts and circumstances at the time the swap is entered into, and should take into account the person's overall hedging and risk mitigation strategies. The Commission expects that a person's overall hedging and risk management strategies will help inform whether or not a particular position is properly considered to hedge or mitigate commercial risk for purposes of the clearing exception.

The Commission should take this same approach herein and recognize that the determination of what is a *bona fide* hedge transaction is informed by a market participant's overall hedging and risk management strategy.

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III. CONCLUSION

BGA appreciates this opportunity to comment and respectfully requests that the Commission consider the comments set forth herein as it develops any final interpretive order in this proceeding.

Respectfully submitted,

/s/ Lisa Yoho____________
Lisa Yoho
Director, Regulatory Affairs

Matt Schatzman
Senior Vice President, Energy Marketing

BG Americas & Global LNG

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
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