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May 15, 2020

VIA ELECTRONIC SUBMISSION

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Proposed Rule, *Position Limits for Derivatives* (RIN 3038-AD99)

Dear Mr. Kirkpatrick:

I. INTRODUCTION

Castleton Commodities International LLC ("**CCI**") respectfully submits this letter in response to the request for public comment set forth in the Commodity Futures Trading Commission's (the "**CFTC**" or "**Commission**") Proposed Rule, *Position Limits for Derivatives* (the "**Proposed Rule**").[1]

CCI is an independent global energy commodities merchant headquartered in Stamford, Connecticut. CCI transacts across the energy commodities value chain through physical and financial trading, asset optimization, and infrastructure investing. As part of its business, CCI owns and operates certain physical assets, such as power plants and natural gas upstream and midstream assets. In addition to its Stamford headquarters, CCI and its subsidiaries operate from offices in Houston, London, Calgary, Singapore, and Shanghai, with assets in various locations around the U.S. and Europe.

CCI supports the Commission's framework for position limits in the Proposed Rule. As described in more detail herein, CCI has identified a few key concerns presented by the Proposed Rule that we believe may be addressed with a limited number of adjustments, which we encourage the Commission to adopt in the final rule. We offer these comments in the spirit of promoting the Commission's goal of preventing excessive speculation while limiting potential impact to legitimate commercial activities and market liquidity.

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[1] Proposed Rule, *Position Limits for Derivatives*, 85 Fed. Reg. 11,596 (Feb. 27, 2020), https://www.cftc.gov/sites/default/files/2020/02/2020-02320a.pdf.

II. COMMENTS OF CCI

A. CCI Supports the Regulatory Framework Set Forth in the Proposed Rule

CCI supports the regulatory framework set forth in the Proposed Rule, and in particular believes that the following aspects of it appropriately address the objective of preventing excessive speculation while preserving legitimate commercial activities:

- Delegating authority to the designated contract markets and swap execution facilities (collectively, the "**Exchanges**") to implement and administer key aspects of the federal speculative position limits regime, including the administration of exemptions for certain "bona fide hedging transactions or positions" ("**BFH**") therefrom;

- Focusing the federal position limits regime for energy market derivatives on the spot month period, which is when contracts are most susceptible to potential distortions;

- Recognizing updated deliverable supply estimates for purposes of establishing federal speculative position limits;

- Adopting an expanded list of enumerated hedge exemptions (each, an "**Enumerated BFH**"), including anticipated merchandising, and permitting a number of the proposed Enumerated BFHs to be utilized on a cross-commodity basis;

- Including a dual track process to pursue BFH exemptions that do not fall within any of the Enumerated BFHs set forth in the Proposed Rule (each, a "**Non-Enumerated BFH**") that would permit an applicant to apply (i) directly to the CFTC or (ii) using a streamlined process administered by the Exchanges;

- Eliminating from federal position limits the prohibition on holding a physically-settled Referenced Contract as a BFH during the last five days of trading during the spot month (or during the time period for the spot month if less than five days) ("**Five Day Rule**");

- Including an exemption from federal speculative position limits for certain enumerated spread transactions;

- Including an exemption from federal speculative position limits for persons under financial distress;

- Excluding trade options from the Referenced Contract definition and providing BFH treatment for Referenced Contracts that hedge trade options; and

- Streamlining reporting requirements, including the proposed elimination of the requirement to file monthly reports of cash market position information under Form 204.

B. Recommendations to Ensure a Workable Final Rule

We recommend that the Proposed Rule be revised to incorporate the limited modifications described below.

1. The Spread Exemption

CCI supports the inclusion of an enumerated spread exemption set forth in proposed Regulations 150.1 and 150.3(a)(2).[2] We believe spreads facilitate risk management across delivery times and locations and commodity grades. At the same time, because of the inherently offsetting nature of spreads, they do not present the risk of excessive speculative concentration as do some other activities.

The definition of spread transaction contained in proposed Regulation 150.1 includes "a calendar spread, intercommodity spread, quality differential spread, processing spread, product or byproduct differential spread, or futures-option spread." Although the preamble text of the Proposed Rule states that the spread exemption would apply to common *types* of inter-commodity and intra-commodity spreads, the set of enumerated spreads set forth in proposed Regulation 150.1 is exclusive and the only intra-commodity spread listed is a "calendar spread."

We urge the Commission to expand the definition of spread transaction to specifically include in the list "intra-commodity spread." This adjustment would provide market participants – particularly those in energy markets – with needed clarity and certainty to promote their ability to enter into spreads in the same underlying commodity (i) in the same class of Referenced Contract, (ii) across classes of Referenced Contracts, or (iii) across markets in Referenced Contracts (*i.e.*, on different Exchanges) in the same or different calendar months.[3]

In addition to covering timing differentials in commodity prices, intra-commodity spreads perform an important function in energy markets by, among other things, promoting price discovery and convergence as well as providing liquidity for priced-linked, physically-settled and cash-settled Referenced Contracts in the same underlying commodity during the spot month as market participants manage their risks across markets. The Proposed Rule implicitly recognizes this point in the context of natural gas markets when it states:

> [I]n natural gas, open interest tends to decline in the NYMEX NG contract approaching expiration and tends to increase rapidly in the ICE cash-settled Henry Hub LD1 contract. These dynamics suggest that cash-settled natural gas contracts serve an important function for hedgers and speculators who wish to recreate

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2 Proposed Rule at 11,622 and 11,638.

3 Proposed Rule at 11,633 (noting that intermarket spreading would be permitted under the federal regime set forth in the Proposed Rule and should address concerns regarding the loss of liquidity under certain commodity derivative contracts).

and/or hedge the physically-settled NYMEX NG contract price without being required to make or take delivery.[4]

In light of the common policy rationale supporting the use of intermarket spreads and intra-commodity spreads, we urge the Commission to adopt an expanded definition of "spread transaction" in CFTC Regulation 150.1 in the final rule that expressly includes in the list "intra-commodity spread."[5]

2. <u>Bona Fide Hedging</u>

a. Conditional Spot Month Limit Exemption for Natural Gas

CCI recommends eliminating the condition that the holder of financially-settled natural gas contracts liquidate all physical positions in order to benefit from the larger conditional spot month limit on financially-settled natural gas set forth in proposed CFTC Regulation 150.3(a)(4). We believe that this condition would have a deleterious impact on liquidity and impair price discovery with respect to the physically-settled natural gas Core Referenced Futures Contract ("**CRFC**"), the NYMEX Henry Hub Natural Gas (NG) futures contract.[6] Such conditions could negatively impact price convergence between futures and cash markets with resulting wider and more volatile expirations that could undermine the confidence of commercial hedgers who rely on the physically-settled natural gas CRFC to manage their risk exposures through the spot month. At the same time, we note that positions in the NG contract will still be subject to limits and Exchange oversight, which provides adequate protection.

b. Guidance for Measuring Risk (Appendix B, Paragraph (a) of Proposed Part 150)

Through the Commission's preliminary determination to adopt guidance addressing the use of gross hedging set forth in Appendix B, paragraph (a) of proposed Part 150, the Proposed Rule appropriately recognizes that gross hedges warrant BFH treatment in circumstances where net cash positions do not necessarily measure total risk exposure due to differences in the timing of cash commitments, the location of stocks, and differences in grades or types of cash commodity. It also recognizes that commercial firms, such as CCI and others, with complex portfolios and transaction structures may have hedging requirements that are not met solely through the use of gross or net hedging.[7]

CCI requests that the guidance set forth in Appendix B, paragraph (a) be revised to clarify that gross hedging may be applied regardless of whether a commercial firm is utilizing

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[4] Proposed Rule at 11,641.

[5] CCI notes that under proposed CFTC Regulation 150.5, the Exchanges maintain the ability to review and approve any exemptions from exchange-set limits.

[6] Such a diminution in liquidity could result from a shift of volume and open interest away from this physically-settled CRFC by swap dealers, non-commercials, and commercial hedgers who use futures markets purely for risk management purposes without participating in the physical delivery process as well as those firms whose underlying physical market positions or business risks are geographically or commercially remote from the primary contract's physical delivery mechanism.

[7] Proposed Rule at 11,613.

an Enumerated BFH or a Non-Enumerated BFH. Specifically, the language in proposed Appendix B, paragraph (a)(1)(D) creates uncertainty as it references proposed CFTC Regulation 150.9, which sets forth the streamlined process for Exchanges to review and grant Non-Enumerated BFHs. CCI believes the CFTC intended to permit the use of gross hedging without having to seek approval through the Non-Enumerated BFH process as the Proposed Rule indicates a clear intent to provide commercial firms with increased flexibility to hedge their exposures to price risk through the use of Enumerated BFHs and Non-Enumerated BFHs.[8] However, given the uncertainty, clarification on this point would be beneficial.

c. *Enumerated BFH for Cross-Commodity Hedges (Appendix A, Paragraph (a)(5) of Proposed Part 150)*

Commercial energy merchant firms, such as CCI, routinely manage a complex portfolio of energy commodities that includes different grades and specifications of commodities and their products and byproducts. Given this diversity of grades and specifications, there often is no liquid commodity derivative contract in the same underlying commodity available for commercial energy firms to use a direct hedge of their identified risk exposures. Consequently, in order to effectively and efficiently manage these risks, they will utilize a commodity derivative contract in a different, but price correlated, commodity to hedge on a cross-commodity basis.[9]

The Proposed Rule adopts a flexible and straightforward approach for utilizing Enumerated BFHs set forth in Appendix A of proposed Part 150 as cross-commodity hedges. Specifically, paragraph (a)(5) in Appendix A would allow a commercial firm to utilize eight of the eleven Enumerated BFHs set forth in Appendix A as cross-commodity hedges without seeking separate approval from the Exchanges or the Commission.[10]

CCI supports this approach. There are two commonly used cross-commodity hedges that were omitted from Appendix A, paragraph (a)(5) without a specific policy justification: Unfilled

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8 Proposed Rule at 11,613. To correct this drafting error, CCI recommends that the CFTC revise Appendix B of proposed Part 150 by removing paragraph (a)(1)(D) as follows:

> (A) The manner in which the person measures risk is consistent over time with and follows a person's regular historical practice for that person;
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> (B) The person is not measuring risk on gross basis to evade federal position limits set forth in § 150.2 or the aggregation rules in § 150.4; and
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> (C) The person is able to demonstrate compliance with paragraphs (A) and (B) upon request of the Commission and/or of designated contract market, including by providing information regarding the entities with which the person aggregates positions.~~; and~~
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> ~~(D) A designated contract market or swap execution facility that recognizes a particular gross hedging position as bona fide pursuant to § 150.9 documents the justification for doing so, and maintains records of such justifications in accordance with § 150.9(d).~~

9 The ultimate determination of which commodity derivative contract functions as the best available cross-commodity hedge is often driven by the fact that (i) the fluctuations in the value of the commodity derivative contract are substantially related to fluctuations in the value of underlying commodity being hedged, and (ii) there is adequate liquidity in the market for the commodity derivative contract.

10 Specifically, the Enumerated BFHs set forth in Appendix A, paragraph (a)(1)-(4) and (a)(6)-(9) may be utilized as cross-commodity hedges.

Anticipated Requirements and Anticipated Merchandising.[11] For the reasons set forth below, we encourage the Commission to revise paragraph (a)(5) to clarify that these enumerated hedge exemptions may be utilized as cross-commodity hedges.

First, commercial energy firms routinely use Referenced Contracts, including physically-settled Referenced Contracts, to hedge their exposure to price risk associated with unfilled anticipated requirements and anticipated merchandising for a particular energy commodity on a cross-commodity basis in a variety of contexts:

- Gasoline Blending. Commercial energy firms that sell finished gasoline often purchase certain gasoline blendstocks, such as Alkylate, Reformate, and Naphtha, from third parties. These blendstocks are often delivered to them from outside of the U.S. Because there is no recognized liquid commodity derivative contract in the same underlying commodities as these blendstocks, commercial energy firms will use the NYMEX RBOB Gasoline (RB) futures contract, a physically-settled Referenced Contract, to hedge price risk exposure associated with their unfilled anticipated requirements. For substantially the same reasons, the NYMEX RB futures contract is viewed as an industry-standard cross-commodity hedge by commercial energy firms that are engaged in the business of merchandising Alkylate, Reformate, Naphtha, or other gasoline blendstocks.

- Aviation "Jet" Fuel. Commercial energy firms may have contractual commitments to supply airlines, airports, or the Department of Defense with aviation fuel (*i.e.,* jet fuel). Such firms may not have the operational capability to refine or otherwise process jet fuel and are required to meet their sales commitments through third-party purchases of this energy commodity. Similar to the gasoline blending scenario above, there is no recognized liquid commodity derivative contract for jet fuel. As such, the standard industry practice is to use the NYMEX NY Harbor ULSD (HO) futures contract as a cross-commodity hedge. The NYMEX HO futures contract is also routinely used as a cross-commodity hedge by commercial energy firms that are engaged in the business of merchandising jet fuel for these very reasons.

- Competitive Solicitations for Electricity Procurement. Commercial energy firms transacting in wholesale power markets will often participate in requests for proposals ("**RFPs**") issued by public utilities, municipal utilities,

[11] The Enumerated BFHs for Unfilled Anticipated Requirements and Anticipated Merchandising are set forth in Appendix A, paragraphs (a)(10) and (a)(11). The Proposed Rule, at 11,612, states that the Commission has preliminarily determined that Request No. 10 set forth in the Bona Fide Hedge Petition filed by The Working Group of Commercial Energy Firms ("**Working Group**"), which involves holding a cross-commodity hedge using a physically-settled Referenced Contract to meet unfilled anticipated requirements would potentially fit in paragraph (a)(5) of Appendix A, if applicable requirements are met. *See* Working Group of Commercial Energy Firms, *Petition for Commission Order Granting Exemptive Relief for Certain Bona Fide Hedging Transactions under Section 4a(a)(7) of the Commodity Exchange Act* (Jan. 20, 2012) ("**BFH Petition**"), http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/wgbfhpetition012012.pdf. However, the text of Appendix A, paragraph (a)(5) fails to reflect this determination. CCI supports the Commission's preliminary determination regarding Request No. 10 in the BFH Petition and requests that the language of Appendix A, paragraph (a)(5) be revised to implement this determination.

> or electric cooperatives. Often, the terms of the RFP require that the bids or offers must be held irrevocably open from the date they are submitted to the RFP holder through the date they are approved and a commercial energy firm is able to execute a power sales agreement with the RFP holder. Prior to submitting such bids or offers, a commercial energy firm will put on hedges using natural gas futures to manage its exposure to price risk in wholesale electricity markets while its irrevocable bid or offer is being considered by the RFP holder. In the power sector, it is standard industry convention to use natural gas futures as a cross-commodity hedge of price risk exposure to electricity prices due to the significant price correlation and substantial liquidity in natural gas markets.[12]

Second, the Exchanges routinely grant hedge exemptions from exchange-set position limits for cross-commodity hedges of unfilled anticipated requirements and anticipated merchandising described above.

The inability to use the Enumerated BFHs for Unfilled Anticipated Requirements and Anticipated Merchandising as cross-commodity hedges could result in the Exchanges being inundated with Non-Enumerated BFH applications from commercial energy merchant firms seeking approval for what is and has been otherwise viewed as routine, industry-standard hedging activity.

d. Enumerated BFH for Anticipated Merchandising (Appendix A, Paragraph (a)(11) of Proposed Part 150) - We Encourage the Commission to Clarify That the Enumerated BFH for Anticipated Merchandising Applies to Hedges of Storage Capacity

The inclusion of Anticipated Merchandising as an Enumerated BFH set forth in Appendix A, paragraph (a)(11) of Part 150 is an important step to ensure the proposed federal position limits regime does not harm legitimate commercial and merchant activity in energy markets. We support a further refinement to expressly recognize hedges of storage capacity as falling within the Enumerated BFH for Anticipated Merchandising.[13]

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[12] This example involves an anticipated merchandising hedge that covers a variation of the facts set forth in Request No. 4 of the Working Group's BFH Petition (Binding, Irrevocable Bids and Offers), which the Commission has preliminarily determined would qualify for the Enumerated BFH for Anticipated Merchandising set forth in Appendix A, paragraph (a)(11). Proposed Rule at 11,611. Given this preliminary determination, CCI is not aware of any policy rationale that would prevent the Commission from clarifying in a final rule that the Enumerated BFH for Anticipated Merchandising may be used as a cross-commodity hedge with respect to binding, irrevocable bids or offers analogous of that contemplated by Request No. 4 of the BFH Petition.

[13] With respect to hedges of storage capacity, the Proposed Rule states the following:

> [O]ther examples of anticipatory merchandising that have been described to the Commission in response to request for comment on proposed rulemakings on position limits (*i.e.*, the storage hedge and hedges of assets owned or anticipated to be owned) would be the type of transactions that market participants may seek through one of the proposed processes for requesting a non-enumerated bona fide hedge recognition.

Proposed Rule at 11,612 n.105.

Storage capacity and the ability to store physical commodities is a highly valuable and critical energy infrastructure asset. The storage hedge is one of the most common and highly-utilized risk reducing practices used by commercial energy firms across the energy industry. Exchanges routinely grant exemptions from exchange-set position limits for such hedges.

Importantly, storage hedges are not used only to manage exposure to price risk associated with the actual commodity being stored – they are also entered into to hedge the potential change in value of storage assets that a commercial energy firm may own or lease or anticipates owning or leasing. In this respect, storage leases are transferrable and a large part of their market value is determined by the then-current calendar spread. Often, holders of storage leases make dynamic decisions about how and when to hedge their storage capacity based upon a number of factors that can affect the value of this critical energy infrastructure asset.[14]

Section 4a(c)(2)(A)(iii)(1) of the CEA directs the Commission to define "bona fide hedging transaction or position" to expressly include hedge of the value of assets that a party owns, lease, or anticipates leasing or owning.[15] We believe it is important to recognize hedges of storage (and anticipated storage) as a BFH in order to adhere to this statutory requirement. Not including this clarification could cause market participants to utilize storage on a less

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[14] These factors include, but are not limited, to: (i) facility-specific operating characteristics; (ii) weather; (iii) regional storage constraints; (iv) pipeline maintenance; (v) "force majeure" events; and (vi) weekly U.S. Energy Information Administration natural gas storage numbers.

[15] Such action would be consistent with the final rule issued by the Commission in November 2011 establishing federal speculative position limits for physical commodities. *See* Final Rule and Interim Final Rule, *Position Limits for Futures and Swaps*, 76 Fed. Reg. 71,626 (Nov. 18, 2011) ("**Vacated Final Rule**"). In relevant part, the Vacated Final Rule stated:

> The Commission recognizes that in some circumstances, such as when a market participant owns or leases an asset in the form of storage capacity, the market participant could establish market positions to reduce the risk associated with returns anticipated from owning or leasing that capacity.
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> . . . .
>
> [T]he Commission will recognize anticipatory merchandising transactions as a bona fide hedge, provided the following conditions are met: (1) The hedger owns or leases storage capacity; (2) the hedge is no larger than the amount of unfilled storage capacity currently, or the amount of reasonably anticipated unfilled storage capacity during the hedging period; (3) the hedge is in the form of a calendar spread (and utilizing a calendar spread is economically appropriate to the reduction of risk associated with the anticipated merchandising activity) with component contract months that settle in not more than twelve months; and (4) no such position is maintained in any physical-delivery Referenced Contract during the last five days of trading of the Core Referenced Futures Contract for agricultural or metal contracts or during the spot month for other commodities.

Vacated Final Rule at 71,646.

On September 28, 2012, the United States District Court for the District of Columbia vacated and remanded this final rule. *See Int'l Swaps and Derivatives Ass'n, et al. v. U.S. Commodity Futures Trading Comm'n*, 887 F. Supp. 2d 259 (D.D.C. Sept. 28, 2012), *appeal dismissed*, 2013 U.S. App. LEXIS 22618 (D.C. Cir. Nov. 6, 2013).

efficient basis, resulting in greater price volatility in the cash and futures markets.[16] Such consequences could harm legitimate commercial hedging activity in energy markets.

Finally, if the Commission does not clarify that storage hedges fall within the Enumerated BFH for Anticipated Merchandising, a significant number of producers, refiners, merchants, public utilities, power generators, and energy marketers transacting in all sectors of the energy industry will be required to seek BFH treatment for storage hedges as Non-Enumerated BFHs. Such activity would be contrary to the Commission's expectation that the Non-Enumerated BFH process would be utilized under "rare and exceptional" circumstances.

e. Five Day Rule (Appendix B, Paragraph (b) of Proposed Part 150)

CCI supports the elimination of the Five Day Rule from the proposed federal regime for position limits. To provide regulatory certainty and avoid harm to legitimate commercial hedging activity in energy markets, CCI respectfully requests for the CFTC to clarify the application of the guidance in Appendix B, paragraph (b) of Proposed Part 150, which pertains to the Five Day Rule.

Specifically, we request that the text of Appendix B, paragraph (b) be revised to clarify that guidance for waiver of the Five Day Rule would only apply to physically-settled Referenced Contracts that are expressly designated by an Exchange as being subject to the Five Day Rule.[17] If an Exchange does not expressly designate a physically-settled Referenced Contract as being subject to the Five Day Rule, then the application of the waiver guidance in Appendix B would

[16] Subsequent to the Vacated Final Rule, in 2013, the Commission's focus on storage hedges shifted from the use of storage by commercial energy firms to providers of "off-farm" storage and the rents they could collect from operating storage capacity. *See* December 2013 Release at 75,719. This was not the basis on which the Commission approved an anticipated merchandising hedge for storage in the Vacated Final Rule and should not be the basis on which it should be considered in this rulemaking. Rather, the instant request for clarification specifically addresses hedging activity engaged in by a commercial energy firm to mitigate exposure to potential changes in value of storage assets that are utilized for purposes of optimizing its own transaction activity in light of applicable market conditions for physical energy commodities. CCI notes that, given the capital intensive nature of owning a storage facility (*i.e.,* fixed cost of the storage facility and the variable costs for labor and fuel, in addition to other costs such as insurance), commercial energy firms generally are not in the business as acting as third-party lessors of storage. Simply put, their focus is not on collecting rents for storage capacity, but on optimizing the operational use of such assets as part of their commercial obligations to purchase or sell physical energy commodities to others and, as applicable, optimize consumption of such commodities. Accordingly, the Commission should recognize that the instant storage hedge request is being presented in a materially different context than when it was last addressed in the December 2013 Release and should be considered accordingly.

[17] CCI's concerns are driven by the fact that the waiver guidance in Appendix B, paragraph (b) does not clearly specify the circumstances under which the Exchanges would be expected to adhere to such guidance. If an Exchange opts not to apply the Five Day Rule to a request for a BFH involving a physically-settled Referenced Contract pursuant to proposed Regulation 150.5(a)(2)(ii)(D), it is not clear whether such Exchange would be expected to follow the waiver guidance in Appendix B, paragraph (b), or whether it could simply take no further action. More importantly, to the extent an Exchange follows the waiver guidance, paragraph (b)(3) of Appendix B contemplates that the commercial firm who has been granted waiver must take the physically-settled Referenced Contract it is holding as BFH in the spot month to physical delivery. Such a result would harm hedging in energy markets by effectively prohibiting firms holding physically-settled Referenced Contracts as a BFH in the spot month for purposes of engaging in, among other things, (i) hedges of unfilled anticipated requirements, (ii) cross-commodity hedges, (ii) storage hedges in crude and natural gas markets, and (iii) exchange for physical ("**EFP**") transactions or alternative delivery procedures ("**ADP**"), which generally are used when counterparties prefer not to perform under the exact terms of a futures contract.

not apply. CCI notes that such a clarification would not otherwise restrict the Exchanges from utilizing other measures to manage and ensure the fair, orderly, and efficient expiry of a physically-settled Referenced Contract held as a BFH in the spot month.

IV. CONCLUSION

CCI appreciates this opportunity to provide input on the Proposed Rule and respectfully requests that the comments set forth herein are considered.

If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ Steven M. Bunkin, Esq.

Executive Vice President, General Counsel and Corporate Secretary

Castleton Commodities International LLC