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Submitted by Email to secretary@cftc.gov
And First-Class Mail

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

Re: Petition for Commission Order Regarding the Applicability of the Bona Fide Hedge Exemption to Certain Transactions

Dear Mr. Stawick:

The American Petroleum Institute ("API") hereby petitions for relief from the Commodity Futures Trading Commission (the "Commission"), under Section 4a(a)(7) of the Commodity Exchange Act ("CEA") and Section 151.5(a)(5) of the Commission's regulations,[1] concerning the applicability of the bona fide hedge exemption. Specifically, we ask the Commission, pursuant to its broad exemptive authority in Section 4a(a)(7) of the CEA, to recognize as bone fide hedging transactions routine energy market transactions that are priced at monthly average index prices. We request this relief pursuant to Section 151.5(a)(5) of the Commission's regulations, which permits "[a]ny person engaging in . . . risk-reducing practices commonly used in the market which they believe may not be specifically enumerated [as hedges to] request relief from . . . the Commission under section 4a(a)(7) of the Act concerning the applicability of the bona fide hedging transaction exemption."

Introduction

API is a national trade association representing more than 450 oil and natural gas companies. API's members transact in physical and financial, exchange-traded, and over-the-counter markets primarily to hedge or mitigate commercial risks associated with their core business of delivering energy to wholesale and retail consumers. API members enter into

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1 Position Limits for Futures and Swaps, 76 Fed. Reg. 71,626, 71,690 (Nov. 18, 2011).

futures, options, and swaps to hedge price risk and facilitate physical transactions. API members range from the largest major oil company to the smallest of independents. They are producers, refiners, suppliers, pipeline operators, and marine transporters, as well as service and supply companies that support all segments of the industry.

On behalf of its members, API respectfully requests that the Commission clarify that the sale or purchase of Referenced Contracts that do not exceed in quantity the unfixed-price purchase or sale of the contract's underlying cash commodity will be treated as enumerated hedging transactions and positions qualifying for the bona fide hedging exemption to position limits.[2] Energy commodities are often priced by reference to a floating metric -- such as, the calendar month average for New York Mercantile Exchange Light Sweet Crude plus or minus a differential -- exposing participants to fluctuating prices. It is critical that participants in energy markets are able to hedge risk associated with these routine unfixed-price purchases and sales. These hedges ultimately reduce risk and volatility in energy markets and facilitate the efficient provision of energy to consumers.

Discussion

I. The Commission should clarify that Referenced Contracts used to hedge risks attendant to the floating-price purchase or sale of an underlying cash commodity qualify as bona fide hedge transactions.

Section 4a of the CEA directs the Commission to set speculative commission limits on positions in futures, options, and economically equivalent contracts "other than bona fide hedge positions." To implement the bona fide hedge exemption, the Commission's rules exempt from position limits a transaction or position in a Referenced Contract that satisfies certain requirements. Among other things, the transaction or position must fall within a list of enumerated hedging transactions and positions.[3]

API seeks bona fide hedging treatment for the purchase or sale of Referenced Contracts that hedge the floating-price purchase or sale of the underlying commodity. API members often do not buy and sell commodities at fixed prices. Rather, as is standard in energy markets, they may buy and sell commodities at calendar-month-average prices. For example, a firm might buy or sell crude oil with the price specified as the average price of NYMEX Light Sweet Crude Oil during the entire spot moth or calendar month. That firm, now exposed to the

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[2] The definition of "Referenced Contract" is set forth in Section 151.1 of the Commission's regulations. *See* Position Limits for Futures and Swaps, 76 Fed. Reg. at 71,685.

[3] *See id.* at 71,689 (Commission Regulation § 151.5(a)(2)).

risk of changing prices, may seek to hedge its exposure to fluctuating prices by buying or selling Referenced Contracts.

API is concerned that these transactions will not fall within the list of enumerated hedging transactions exempt from position limits set by the Commission. Because the underlying commodity is purchased or sold at a monthly average price, rather than at a fixed price, API is concerned that the enumerated hedge exemptions for sales or purchases of referenced contracts that do not exceed the fixed-price purchase or sale, respectively, of the contract's underlying cash commodity will not apply.[4] The Commission has also provided an enumerated hedge exemption for "[o]ffsetting 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."[5] API is concerned that this exception might be too narrow to reach the full scope of routine transactions used by energy companies to hedge risks associated with floating-price transactions in the cash commodity. Accordingly, we ask that the Commission make clear that the transactions in Referenced Contracts that hedge physical commodity transactions priced at calendar or other average index prices, are enumerated bona fide hedging transactions.

In this regard, API fully supports the requests for exemptive relief contained in the 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 dated January 20, 2012. In that Petition, the Working Group sought bona fide hedge treatment for, among other things, Referenced Contracts used to lock in a price differential where one leg of the underlying transaction is a floating-price commitment to buy or sell a physical energy commodity and the offsetting sale or purchase has not been completed. As the Working Group explained, a party may enter into a firm, floating-price, physical commitment to buy a commodity because market conditions make it profitable to buy the commodity and move it to a location where it is needed. For example, the party may buy oil at a floating price based on the ICE Brent crude contract and plan to sell it in the United States in the Gulf of Mexico at a sale not yet arranged but often priced off the NYMEX Light Sweet Crude Oil contract. The party must lock in the economics that make this sale profitable by buying ICE Brent futures and selling NYMEX Light Sweet Crude Oil futures. These transactions protect the party from the risk that the price it has agreed to pay for the oil will rise relative to the NYMEX Light Sweet Crude Oil price at which it will sell the oil. Of course, the same is also true in reverse.

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4 *See id.* (Commission Regulation § 151.5(a)(2)(i)-(ii)).

5 *See id.* (Commission Regulation § 151.5(a)(2)(iii)).

II. The sale or purchase of Referenced Contracts that hedge the floating-price purchase or sale of a cash commodity conform to the general definition of bona fide hedging.

As the foregoing description makes clear, the use of Referenced Contracts to hedge the floating-price purchase or sale of a commodity satisfies the general definition of bona fide hedging. First, buying or selling Referenced Contracts is 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.[6] For example, once oil is purchased, the sale of NYMEX Light Sweet Crude Oil Referenced Contract is a substitute for selling the oil at a later time in a physical marketing channel.[7] Second, the transaction is "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."[8] In this regard, API does not seek an exemption that is broader than the quantity of the underlying commodity that has been purchased or sold. Third, the transaction arises from the potential change in the value of an asset -- for example, oil -- that an API member owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising.[9] Alternatively, some such transactions could reduce risks attendant to a position resulting from a swap that qualified for bona fide hedging treatment.[10]

III. Exempting Referenced Contracts that hedge the floating-price purchase or sale of a cash commodity will promote the efficient functioning of energy markets.

It is critical that participants in energy markets are able to hedge risk. Given the prevalence of floating-price contracts for energy commodities -- such as, standard NYMEX Light Sweet Crude Oil calendar-month-average pricing -- participants in energy markets will often be exposed to fluctuating prices associated with the floating-price purchase or sale of commodities. These transactions are not speculative; they are simply how energy market participants buy and sell commodities. For example, a refinery processes crude seven days a week, but most crude pricing only occurs five days a week. This can lead to a timing imbalance that can be accounted for with calendar-month-average pricing. And participants in energy markets need to be able to hedge risk associated with floating-price transactions without worrying that they will exceed speculative position limits.

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6 *See id.* (Commission Regulation § 151.5(a)(1)(i)).

7 *Cf. id.* at 71,696 (Appendix B to Part 151, Example 3) ("Selling NYMEX Light Sweet Crude Oil Referenced Contracts is a substitute for transactions to be taken at a later time in the physical marketing channel once the oil is produced.").

8 *Id.* at 71,689 (Commission Regulation § 151.5(a)(1)(ii)).

9 *See id.* (Commission Regulation § 151.5(a)(1)(iii)).

10 *See id.* (Commission Regulation § 151.5(a)(1)(iv)).

The use of Referenced Contracts to hedge risk associated with the floating-price purchase or sale of energy commodities is also critical to the effective functioning of energy markets. Energy providers depend on the ability to lock in favorable economic conditions that make it profitable for them to move energy from where it exists to where it is needed. The Commission's position limits regime should not threaten these transactions that facilitate the efficient flow of energy to American consumers. Nor should the regime unnecessarily classify hedging transactions as speculative, so as to raise the costs of energy to American consumers.

Conclusion

For the foregoing reasons, API respectfully requests that the Commission clarify that the sale or purchase of Referenced Contracts that do not exceed in quantity the unfixed-price purchase or sale of the contract's underlying cash commodity will be treated as enumerated hedging transactions and positions qualifying for the bona fide hedging exemption to position limits.

Should you have any questions, please do not hesitate to contact me.

Respectfully submitted,

Brian Knapp

Policy Advisor,
American Petroleum Institute

cc: Honorable Gary Gensler, Chairman
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O'Malia, Commissioner
Honorable Mark P. Wetjen, Commissioner