CFTC Energy and Environmental Markets Advisory Committee (EEMAC)

Report on EEMAC's 2015 Review and Consideration of the CFTC's Proposed Rule on Position Limits

February 25, 2016

1. Introduction and Executive Summary[1]

Section 751 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[2] mandated that the Commodity Futures Trading Commission ("CFTC" or "Commission") create an Energy and Environmental Markets Advisory Committee ("EEMAC") for the purpose of "submitting reports and recommendations to the Commission" and "to serve as a vehicle for discussion and communication on matters of concern to exchanges, firms, end users and regulators regarding energy and environmental markets and their regulation by the Commission."[3] Pursuant to this mandate, and as required by Congress,[4] the EEMAC held two meetings in 2015, the first on February 26th and the second on July 29th. In those meetings, the EEMAC extensively considered the CFTC's 2013 Proposed Rule ("Proposed Rule") mandating new federal position limits for energy futures, options and swaps beyond the decades-old federal position limits for agricultural commodities and existing position limits set by U.S.

[1] Prior to review and approval by the Members of EEMAC, thanks must go to Professor Craig Pirrong and Mr. James Allison for preparing an initial draft of this report.
[2] Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[3] *Id.* § 751.
[4] 7 U.S.C. § 2(a)(15)(B)(i) (2012).

futures exchanges.[5] This report serves as a summary of those proceedings and states the formal recommendations of EEMAC to the CFTC about the Proposed Rule for position limits.[6]

a. Observations of the Committee

Specifically, the EEMAC broadly agrees on three primary market observations:

1. **There is little to no evidence that the CFTC's Proposed Rule mandating new federal position limits is sufficiently "necessary" to satisfy the explicit requirement under the Commodity Exchange Act**.[7] In the absence of evidence of necessity, it is unlikely that any final federal speculative position limit rule could pass a cost/benefit test.[8]

2. **There are already concerns with a sharp reduction of trading liquidity in the relevant physical and derivative markets, adversely affecting the ability of end users to hedge**. The Proposed Rule, if implemented without substantial changes, would exacerbate the adverse effects on hedging[9] and undermine the ability of energy derivatives markets to perform their economic functions of risk transfer and price discovery while avoiding unwarranted fluctuations in prices due to excessive speculation.

3. **Implementation of a new federal speculative position limits regime will create abundant practical challenges**. These challenges can be reduced—but not eliminated—by drawing upon existing resources and expertise within the exchanges and through modifications to the Proposed Rule (such as use of accountability levels rather than hard limits).[10]

The discussion below expands upon these summary observations.

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[5] *See* Position Limits for Derivatives, 78 Fed. Reg. 75,680 (Dec. 12, 2013), https://www.gpo.gov/fdsys/pkg/FR-2013-12-12/pdf/2013-27200.pdf.

[6] *See Energy & Environmental Markets Advisory Committee Meetings*, CFTC COMMITTEES, http://www.cftc.gov/About/CFTCCommittees/EnergyEnvironmentalMarketsAdvisory/emac_meetings.

[7] The necessity requirement for imposing federal position limits was first required under the Commodity Exchange Act in 1936. *See* CEA Sec. 4a(a)(1).

[8] February 26, 2015 EEMAC Transcript [*hereinafter* Feb. 26 Tr.] at 36-39.

[9] July 29, 2015 EEMAC Transcript [*hereinafter* July 29 Tr.] at 34, 36-37, 97-98, 102-04, 110-11, 116-19, 124-26, 132-33, 137-38, 141-43; Feb. 26 Tr. at 79-83, 89-92, 95-96, 103-04, 115-18, 134-35, 140-41, 144-45, 156-74, 182-91.

[10] July 29 Tr. at 19, 27-31, 34-36, 43, 111-12, 117-20, 129-30; Feb. 26 Tr. at 98-99, 101-02, 115-24.

2. Discussion of the 2013 CFTC Position Limits Proposed Rule

The participants in the two EEMAC meetings also agreed broadly on most major issues that were addressed. In particular, the participants in both EEMAC meetings reached a nearly unanimous consensus on the following:

- New federal position limits are not demonstrably necessary to prevent excessive speculation or associated fluctuations in prices. To the contrary, there is little or no evidence that excessive speculation exists or has existed (outside of a few limited, and rather dated, instances). In the words of one participant, the Proposed Rule is "a solution to a non-existent problem" (Erik Haas, Feb. 26 Tr. at 70).
- Under the Proposed Rule, new position limits are likely to have the serious unintended consequence of further reducing liquidity in energy derivatives, especially for those with delivery dates beyond the first several months (i.e., "further out on the curve"). This reduced liquidity would harm hedgers, who are already having trouble accessing liquidity, particularly in smaller, more regional power and gas markets (Feb. 26 Tr. at 220-22).
- The Commission's proposed restriction of *bona fide* hedging to a limited set of "enumerated hedges" is unnecessarily restrictive and contrary to standard, prudent risk management activities in energy markets. The CFTC's proposed enumerated hedges exclude many commonly utilized risk management strategies. Thus, limiting *bona fide* hedging to the proposed enumerated hedges would have the unintended, and highly

deleterious, effect of unnecessarily constraining effective energy hedging strategies (July 29 Tr. at 34, 36-37, 81-82, 93, 97-98, 110-11; Feb. 26 Tr. at 134, 160-62, 179-82, 238-39).

- A position accountability regime patterned on existing practices of Designated Contract Markets ("DCMs," or "exchanges") is a reasonable alternative to the CFTC's 2013 Proposed Rule containing a system of rigid position limits. An accountability regime would achieve the public purpose of addressing the destabilizing impact of any excessive speculation, while taking into account the varied hedging needs of market participants and the impact on liquidity of restrictions on the positions or trading of any market participant (July 29 Tr. at 27-31, 111-12, 117-20, 129-30; Feb. 26 Tr. at 98-99, 101-02, 115-24).
- Exchanges should play a central role in the process of evaluating and granting hedging exemptions for non-enumerated hedges (July 29 Tr. at 19, 34-36, 43).
- If it decides to impose limits, the Commission should take a phased approach. It should start with spot month limits, and then proceed to implement limits outside the spot month in a separate rulemaking only if a thorough analysis of comprehensive and current market data demonstrates the need for such limits (July 29 Tr. at 101-13, 116-23, 126-28, 132-35, 138-40).
- Spot month limits must be based on up-to-date data on deliverable supplies, and measures of deliverable supply that reflect differences

between distinct types of energy commodities, and between energy and non-energy commodities (July 29 Tr. at 100, 133; Feb. 26 Tr. at 99-101, 124-26, 129-33, 249).

- Trade options and forward contracts with volumetric optionality must not be included in any position limits regime (July 29 Tr. at 179, 196-99; Feb. 26 Tr. at 218-25).

a. The Proposed Rule Fails the Decades-Old Necessity Finding Required by the Commodity Exchange Act

The Committee examined in detail whether adopting an entirely new regulatory regime for imposing position limits is necessary to prevent excessive speculation in energy derivatives markets, and the clear consensus was that it is not.

In the February 2015 meeting, Professor Craig Pirrong presented an overview of the academic literature on the impact of speculation in commodity markets. He stated that although some studies purport to demonstrate an adverse impact from speculation, the execution of these studies, their interpretation, or both, fail to support these conclusions. To the contrary, the bulk of the economic literature fails to document any adverse impacts from speculation (Feb. 26 Tr. at 28-40).[11]

At the same meeting, Energy Information Agency ("EIA") Administrator Adam Sieminski reviewed data produced by the EIA showing that the sharp decline in oil prices in 2014-2015 was not caused by speculation, but instead was the result of basic economic

[11] For recent studies see, for example, the two economic research papers filed by Jing Cynthia Wu, Assistant Professor of Econometrics and Statistics, the University of Chicago Booth School of Business in the comments following the February 2015 EEMAC meeting. These two papers, both coauthored by James D. Hamilton (Professor of Economics, University of California, San Diego) and Professor Wu, found no credible evidence of excessive speculation or of index-fund investment affecting commodity futures prices. These studies refute the findings from Singleton that purported to find such evidence. The comment filing is available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=60365

fundamentals: global supply has outpaced demand, leading to lower energy prices (Feb 26 Tr. at 21). This conclusion is similar to testimony of the CFTC's then-Chief Economist before committees in both Houses of Congress concluding that there was "little evidence that changes in speculative positions [were] systematically driving up crude oil prices" that peaked in July 2008.[12]

Similarly, EEMAC participant Thomas LaSala, representing the CME Group, presented recent evidence demonstrating "no discernable impact" of swap dealer positions, managed money positions, or index positions on the price of West Texas Intermediate Crude Oil Futures (Feb. 26 Tr. at 70-75).

In addition, the EEMAC heard unrefuted evidence that energy derivatives markets are generally functioning well, particularly in the spot month. In fact, Eric Haas, representing the Intercontinental Exchange ("ICE"), presented evidence demonstrating that energy markets are exhibiting "model convergence," which ensures that they are venues for accurate price discovery and successful risk management (Feb. 26 Tr. at 68-70).

EEMAC meeting participants generally concurred in the view that as proposed, position limits are unnecessary because excessive speculation is not evident in the energy markets; as EEMAC member Michael Cosgrove noted:

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[12] *Testimony Before the S. Comm. on Energy & Natural Resources*, 110th Cong. 17 (2008) (statement of Jeffrey Harris, Chief Economist, CFTC), http://www.energy.senate.gov/public/index.cfm/files/serve?File_id=150704a1-d7f9-7eca-e6d2-3384e16b17fd; *Testimony Before the Subcomm. on General Farm Commodities & Risk Management of the H. Comm. on Agriculture*, 110th Cong. 5-24 (2008) (statement of Jeffrey Harris, Chief Economist, CFTC), https://archives-agriculture.house.gov/sites/republicans.agriculture.house.gov/files/testimony/110/110-37.pdf; *see also* BAHATTIN BÜYÜKŞAHIN & JEFFREY HARRIS, CFTC, THE ROLE OF SPECULATORS IN THE CRUDE OIL FUTURES MARKET 1, 16-19 (2009), http://www.cftc.gov/idc/groups/public/@swaps/documents/file/plstudy_19_cftc.pdf.

> Instead of being obvious, it is undetectable. If we claim that elephants were playing in the backyard then we would expect to see their footprints. The alleged excessive speculation, if it is taking place, is leaving no data footprints.[13]

b. The Proposed Rule for Position Limits Poses a Serious Threat to Energy Market Liquidity

EEMAC meeting participants voiced alarm at the potential detrimental effect of the Proposed Rule on market liquidity and noted that declines in liquidity impair the ability of energy derivatives markets to serve their risk-transfer and price-discovery functions. These concerns were particularly pronounced with regard to back-month contracts and smaller contracts. As Erik Haas put it: “single and all-month limits will only serve to eliminate already thin liquidity out the curve” (Feb. 26 Tr. at 96). EEMAC members expressed particular concern that the reduction in liquidity stems from the withdrawal of speculators from the markets, while Lael Campbell of Exelon pointed out there was an “excessive hedging problem” in some markets and expressed a desire for *increased* speculator participation in energy markets to enhance liquidity (Feb. 26 Tr. at 81-83).

At the July 2015 EEMAC meeting, data was presented documenting the widening in bid-ask spreads and the reduction in market depth (i.e., the number of contracts that can trade in a day without impacting price) that have already occurred in the natural gas

[13] Michael A. Cosgrove, Vectra Capital LLC, Comment Letter on Re-Proposal of Position Limits (Mar. 24, 2015), at 1, http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=60369&SearchText=vectra%20capital; *see also* Stephen Berger, July 29 Tr. at 116; William McCoy, July 29 Tr. at 108 (stating that the Commission “should take particular care….to find that position limits outside the spot month are necessary….”).

markets.[14] Prompt month bid-ask spreads have widened since the pre-Dodd-Frank period for most larger and secondary natural gas markets.[15]

The deterioration in liquidity is even more pronounced for natural gas deferred contract strips, such as the November-March and April-October strips. Spreads have widened since the pre-Dodd-Frank period for ten of twelve locations for the November-March strip, and ten of twelve locations for the April-October strip. Some of the changes in spreads have been quite large, reaching as much as 400%.

As mentioned above, market depth has also declined noticeably. For instance, whereas in major markets it was possible to trade five contracts per day without moving the price appreciably in the pre-Dodd-Frank era, at present it is only possible to trade one contract. In smaller markets, depth has fallen by more than ninety percent, making it impossible to trade in these markets without moving the price.

Given the substantial drop in trading liquidity (and market depth) that has already occurred, a broad consensus of the Committee agreed that the Proposed Rule for position limits would harm liquidity even further and that any additional decline would impose substantial costs on hedgers.[16] Participants argued that decreased liquidity would harm hedgers.[17]

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[14] *See Presentation on Natural Gas Financial Basis Bid/Ask Spreads and Market Depth at the July 29, 2015 EEMAC Meeting*, ENERGY & ENVIRONMENTAL MARKETS ADVISORY COMMITTEE, http://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/eemac072915_bidask.pdf.

[15] *Id.*

[16] EEMAC meeting participants who stated that position limits threatened to impair liquidity included: Ron Oppenheimer (Feb. 26 Tr. at 80); Thomas LaSala (Feb. 26 Tr. at 134; July 29 Tr. at 26); Sharon Brown-Hruska (Feb. 26 Tr. at 140-41); Joseph Nicosia (Feb. 26 Tr. at 185); Benjamin Jackson (Feb. 26 Tr. at 209); Todd Creek (July 29 Tr. at 79); William McCoy (July 29 Tr. at 108); Lael Campbell (July 29 Tr. at 137); and James Allison (July 29 Tr. at 142).

[17] When polled by Commissioner Giancarlo, participants were unanimous in their belief that trade options and forward contracts with volumetric optionality should be excluded from position limits (Feb. 26 Tr. at 223-25).

c. The Enumerated Hedges in the 2013 Proposed Rule are Excessively Narrow

EEMAC meeting participants expressed serious concerns that the enumerated hedges specified in the Proposed Rule are excessively narrow, and would limit, and perhaps eliminate, many prudent uses of energy derivatives contracts to transfer risk (July 29 Tr. at 34, 36-37, 81-82, 93, 97-98, 110-11; Feb. 26 Tr. at 134, 160-62, 179-82, 238-39). Reduction or elimination of these hedging strategies would increase the risk of pricing commodities, the cost of which "is ultimately borne by consumers" (Feb. 26 Tr. at 157-58, 179-80, 183-85). Participants also heard evidence that increased energy costs will be felt most heavily by low-income Americans (Feb. 26 Tr. at 196-99).

Participants mentioned several specific examples of widely utilized hedges that would fall outside of the scope of those enumerated in the Proposed Rule. One notable example was the use of spread trades to hedge floating price exposures in different but related markets, such as the purchase of oil indexed to Brent and the sale of oil indexed to WTI (Ron Oppenheimer, Feb. 26 Tr. at 156-67). Other notable examples include synthetic storage (Ron Oppenheimer, Feb. 26 Tr. at 170-74; Arushi Sharma-Frank, Feb. 26 Tr. at 175-76) and cross hedges (e.g., using natural gas derivatives to hedge power price risk) (Thomas LaSala, Feb. 26 Tr. at 115-16; Joseph Nicosia, Feb. 26 Tr. at 191; Herbert Thornhill, Feb. 26 Tr. at 200-03). It was troubling to the Committee that the Commission has proposed to tighten these restrictions in its 2013 Proposed Rule after the prior 2011 version of the rule was vacated by the U.S. District Court for the District of Columbia (Feb. 26 Tr. at 170-76). The Committee finds it even more troubling that no cogent rationale was expressed for limiting these hedges (Feb. 26 Tr. at 178-79).

Other participants expressing deep misgivings about the proposed enumerated hedges included Dena Wiggins (Feb. 26 Tr. at 205-06); Lael Campbell (Feb. 26 Tr. at 207-08); Benjamin Jackson (Feb. 26 Tr. at 208-09); Sharon Brown-Hruska (Feb. 26 Tr. at 238-39); Erik Haas (Feb. 26 Tr. at 101-04); and Todd Creek (July 29 Tr. at 81-82).

d. An Expanded Accountability Regime is a More Workable Alternative to Single and All-Month Limits

At the July meeting of EEMAC, Thomas LaSala and Erik Haas presented comprehensive reviews of the position accountability regimes in place at their respective DCMs (July 29 Tr. at 24-32). LaSala and Haas also described the process by which CME and ICE evaluate and grant hedging exemptions, and how this process could be utilized to grant exemptions for non-enumerated hedges as part of a new federal regime (July 29 Tr. at 49-57).

EEMAC meeting participants were broadly in agreement that an accountability regime could achieve the purpose of constraining excessive speculation in a far less burdensome way than would be mandated in the Proposed Rule. During the July meeting, Mr. LaSala described the operation of the accountability system, emphasizing that CME attempted to avoid "squelch[ing] liquidity" (July 29 Tr. at 26) and treated differently position concentrations at unique points of the curve (July 29 Tr. at 27). Positions in excess of limits can be maintained, insofar as they do not affect the market (July 29 Tr. at 29), but on several occasions CME has required the reduction of positions (July 29 Tr. at 31-32).

Mr. Haas described ICE's exemption process (July 29 Tr. at 49-53, 55-57), and Mr. LaSala explained CME's (July 29 Tr. at 54-57). Both emphasized how the process balances the needs of the hedger with the need to avoid market disruption. They stated

that they believed the exchanges could continue to play a role in managing a federal position accountability system, but acknowledged that CFTC involvement was necessary to extend this to the over-the-counter ("OTC") market (July 29 Tr. at 58-62). LaSala further acknowledged that the issue of whether DCMs could work with those who strictly trade OTC needs further review (July 29 Tr. at 86-87).

The overwhelming majority of members of the EEMAC expressed broad support for a position accountability system in lieu of the regime established in the Proposed Rule a role for DCMs in administering this system and the granting of hedge exemptions. Participants expressing this view included Lopa Parikh (July 29 Tr. at 82-84); Mike Gill (July 29 Tr. at 85-86); Dena Wiggins (July 29 Tr. at 89); and William McCoy (July 29 Tr. at 111-12).

Tyson Slocum of Public Citizen questioned whether DCMs, as for-profit entities, could maintain independence while performing these responsibilities (July 29 Tr. at 74, 76-77). DCM representatives Haas and LaSala stated that they could and described various procedural and organizational "firewalls" intended to ensure the independence of their exchanges' compliance functions (July 29 Tr. at 74-78).

e. A Phased Approach Commencing with Spot Month Limits is Preferable

There was broad consensus at the July 2015 EEMAC meeting that any Commission position limits initiative should begin first with spot month limits and only proceed to limits outside the spot month in a separate rulemaking, after a separate Commission vote finding a demonstrated need based on a thorough analysis of reliable data. William McCoy gave three reasons for a phased approach: (1) it provides time for market participants to achieve compliance; (2) it focuses on the most active months; and (3) it gives the Commission time to consider and modify its approach based on

experience with the spot month limits (July 29 Tr. at 105). Those expressing support for a phased approach included: Y.J. Bourgeois (July 29 Tr. at 101); Stephen Berger (July 29 Tr. at 116-17); and Lael Campbell (July 29 Tr. at 137-38).

One concern among the participants was the need to update the deliverable supply estimates and methodologies used as the basis for setting spot month limits (Y.J. Bourgeois, July 29 Tr. at 100; Benjamin Jackson, July 29 Tr. at 133; Erik Haas, Feb 26 Tr. at 99-101; Thomas LaSala, Feb. 26 Tr. at 116-17; Dena Wiggins, Feb. 26 Tr. at 124-26; Herbert Thornhill, Feb. 26 Tr. at 129-33). There was disagreement among the participants regarding whether different spot month limits were appropriate for delivery-settled and financially-settled derivatives (Y.J. Bourgeois, July 29 Tr. at 99, 101; James Allison, July 29 Tr. at 141; Bryan Durkin, July 29 Tr. at 130; Craig Pirrong, July 29 Tr. at 135).

There was widespread agreement that any move to implement limits outside the spot month should only proceed after a thorough analysis of reliable data and methodology (William McCoy, July 29 Tr. at 107-10; Stephen Berger, July 29 Tr. at 116-20; Lopa Parikh, July 29 Tr. at 134; Sharon Brown-Hruska, Feb. 26 Tr. at 141-42).

3. Conclusion and Recommendations

It is the considered view of the Energy and Environmental Markets Advisory Committee that the CFTC should not finalize the position limits rule, as proposed. The EEMAC finds scant evidence that the Proposed Rule is necessary or would be effective to limit excessive speculation in energy markets. On the contrary, to the extent the EEMAC identified problems in energy and environmental markets related to speculative activity, the problem is *insufficient* speculative activity, which is limiting—

sometimes dramatically—the liquidity available to hedgers. The EEMAC believes that implementing the proposed position limits rule may cause significant and foreseeable harm to the ability of end users to control production costs at a time of plummeting prices in U.S. energy commodity and derivatives markets.

a. Recommendations

If the CFTC does intend to move forward with the Proposed Rule, despite the lack of necessity, the EEMAC recommends that a number of critical concerns be addressed in any final rule:

1. **Address Flaws with *Bona Fide* Hedging**. The Commission must address the flaws in its broad and unprecedented restriction of *bona fide* hedging activity.
2. **Impose Position Limits Only in the Spot Month**. The Commission should initially impose position limits only in the spot month, reserving non-spot month limits for a future Commission vote after data on federal spot month position limits is collected and analyzed.
3. **Update Deliverable Supply Estimates Using Current Market Data**. The Commission must use updated estimates of deliverable supply that are attuned to the particular characteristics of each commodity on which position limits are imposed.
4. **Utilize Decades-Old Existing Expertise of U.S. Exchanges**. The Commission should utilize the expertise, experience and resources of exchanges to implement any position limits rule. Exchanges, by virtue of their decades of experience and interaction with market participants, are especially

well-positioned to grant hedge exemptions and administer a position accountability regime.

Following these steps could help make any final CFTC federal speculative position limits rule more workable and minimize harm to the U.S. economy that would otherwise result by imposing regulations that restrict the ability to hedge during increasingly volatile commodity markets and needlessly raise prices for millions of everyday American consumers of energy.

Members Voting to Approve:

James Allison
Michael Cosgrove
Bryan Durkin
Benjamin Jackson
William McCoy
Craig Pirrong
Lopa Parikh
Dena Wiggins

Members Voting to Dissent:

Tyson Slocum; see separate written dissent.