AMERICAN PUBLIC GAS ASSOCIATION

April 4, 2011

Filed Electronically

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

Re: Commodity Options and Agricultural Swaps, 76 Fed. Reg. 6095 (Feb. 3, 2011), RIN No. 3038-AD21.

Dear Mr. Stawick:

The American Public Gas Association ("APGA") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission") proposed rules entitled, "Commodity Options and Agricultural Swaps," 76 *Fed. Reg.* 6095 (Feb. 3, 2011) ("Proposal"). The Commission is proposing to amend Part 32 of its rules, which govern the trading of options, in response to Section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").[1] Section 721 of the Dodd-Frank Act amends the Commodity Exchange Act, 7 U.S.C. §1 e*t seq.* by including "options" within the new definition of "swap."

APGA

APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and over 700 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, and other public agencies that have natural gas distribution facilities.

APGA members must have assured sources of supply of natural gas in order to provide their customers natural gas to operate their factories, heat their homes and cook their food. As retail distribution entities, APGA members regularly purchase natural gas in cash market transactions, often in the form of long-term supply contracts. APGA members may also engage in swaps transactions to hedge or mitigate the risk of their cash market purchases of natural gas. Accordingly, APGA members are sophisticated participants in both the wholesale cash markets and OTC swaps markets.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111–203, 124 Stat. 1376 (2010) ("Dodd-Frank").

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The Proposed Rules

Currently, Commission rule 32.4, 17 C.F.R.§32.4, provides an exemption from all Commission rules (except those relating to misrepresentation and fraud) for commodity options reasonably believed to be offered to a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the option transaction and that is entered into by the producer, processor, commercial user or merchant for a business-related purpose. This is commonly known as the "trade option exemption." The Commission is proposing to replace the trade option exemption of rule 32.4 with a new rule that provides that persons offering to enter into transactions that are commodity option transactions may do so under the provisions of the Act and Commission rules applicable to swaps.

The Commission is proposing to remove the trade option exemption based on its reasoning that

> the swaps rules already allow for the equivalent of a trade option—the Dodd-Frank amendments permit bilateral swaps, where both parties are ECPs [Eligible Contract Participants] to remain uncleared at the election of a commercial end user.[2]

Natural Gas Cash Market Transactions

During the winter heating months, demand for natural gas varies depending upon the weather from one day to the next. A utility's need for natural gas supply during this period is often difficult to predict. In order to ensure their customers a reliable gas supply whenever they need it, APGA members enter into various contracts to purchase natural gas. A common type of purchase arrangement enables the APGA member to reserve a certain amount of capacity for a specified period in exchange for a "demand charge" or payment. Thus, if the weather requires it, the APGA member can take delivery of supplies sufficient to meet the demand of its customers. If weather is warmer, then the member does not take delivery of the unneeded supply. The parties to these contracts intend to take delivery of the commodity whenever supplies are needed.

These arrangements are known in the natural gas trade by a number of different names. They are known as a "swing" contract, a "peaking" contract or sometimes a "call option." These contracts generally include a "demand charge" which is also known as a "reservation charge" or a "premium." As noted above, under the contract, the APGA member has the right to demand delivery of physical supplies of natural gas in any amount up to the reserved amount. Typically, the natural gas that is delivered under the contract is priced based upon the spot price for the commodity when delivered. Accordingly, the contract assures APGA's member that it will be able to purchase and stand for delivery of natural gas when and as needed; it does not provide a price floor or ceiling. On occasion, without having such contracts available, APGA members have encountered situations when no incremental supplies were available during cold weather.

A specific example is as follows. The utility would acquire swing rights, or buy the "call," to obtain firm rights to the underlying gas supplies on an as-needed basis for the winter

[2] Proposal at 6102.

season. The contract would have an effective term of Nov 11 - Mar 12, an underlying quantity of 10,000 Dt/day, a demand charge of $0.015 per Dt (paid whether or not any natural gas supply is actually taken), and an underlying indexed gas price of the Gas Daily Midpoint for the closest pricing Hub. The utility must notify the supplier by 6:30 AM the day before it wants to take delivery. The market pricing of the underlying gas is the spot price for that day, an indication that the contract is intended to assure firm physical gas availability, with no price hedging purpose. The utility may manage the relative price risk separately from this physical supply contract in the financial markets (e.g. with swaps and financial options). This swing contract only ensures adequate supplies when market demand increases.

These swing contracts are essential to the utility because it needs the rights to firm physical supplies to help meet load uncertainties. Such rights serve a commercial purpose by filling the intermediate space between owning a less expensive baseload supply (flat, uniform daily take requirement) and the more expensive storage injection and withdrawal rights.

These contracts are not "swaps"

As noted above, the definition of "swap" includes "options." Natural gas swing contracts, and other variations on such cash contracts, provide assurance to the APGA member that it will be able to purchase physical supplies of gas when needed. Although these contracts are also referred to colloquially as "call options," the Commission historically "has carefully examined 'the economic reality of the transaction, not its name' to determine whether an instrument is an option." Here, although the purchaser has the right to vary the amount that it takes on delivery from day to day, these contracts do not have many of the characteristics that the Commission traditionally has associated with "options." For example, these contracts are not "limited risk" contracts in which the "purchaser will benefit from a favorable price move."[3] Unlike an option, the purchaser of a natural gas swing contract "face(s) the full risk of loss from adverse price changes."[4]

The definition of "swap" includes an exclusion for "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."[5] The exclusion from the definition of "swap" was clearly intended by Congress to ensure that cash market transactions, including contracts for deferred delivery, are not subject to regulation as a swaps contract. This exclusion from the definition of "swap" parallels the "forward contract exclusion" from the definition of "contract for future delivery," which has been incorporated into the law for 90 years.

It is clear that the parties to a swing contract intend to take (make) delivery under the contract, but have deferred delivery for commercial convenience. The utility has the right to claim deliveries under the contract in whatever amount that it needs from day-to-day up to the contract limits. Variation in the amount that is delivered under the contract is dependent upon the physical need for the commodity. The demand charge is paid whether or not delivery is taken, but that is no different in concept than the system charges that all residential natural gas

[3] See Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options," 50 *Fed. Reg*. 39656, 39659 (September 30, 1985).
[4] Id.
[5] Section 1a(47)(B)(ii) of the Act.

users pay to their utility during the summer months. If the utility wishes to hedge price risk, it typically does so by entering into a separate, financial contract.

The Commission should provide guidance with respect to these contracts

Although natural gas swing and similar forms of contracts clearly fall within the exclusion from the definition of "swap" for "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled," there are no bright line tests for differentiating cash forward contracts from regulated swaps transactions. In this regard, it should be noted that the definition of "option" under the Act is itself imprecise.[6] Chairman Gensler in testimony to Congress stated that

> under the Commodity Exchange Act, the CFTC does not regulate forward contracts. Over the decades, there has been a series of orders, interpretations and cases that market participants have come to rely upon regarding the exception from futures regulation for forwards and forwards with embedded options. Consistent with that history, the Dodd-Frank Act excluded from the definition of swaps "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." I believe it would be appropriate to interpret that exclusion in a manner that is consistent with the Commission's previous history of the forward exclusion from futures regulation, including the Commission's treatment of bookouts.[7]

APGA welcomes the Commission's application of its prior interpretations of "forward contract" to the exclusion from the definition of swaps for deferred delivery contracts.[8] As Chairman Gensler noted, the Commission has previously issued guidance on forwards with embedded options.[9] However, those interpretations are fact specific and do not address many variants of contracts, such as the natural gas swing contracts. Indeed, as long as the Act excluded all individually negotiated contracts between Eligible Contract Participants and Commission rule 32.4 exempted trade options, it was unnecessary for the Commission to do so.

However, to the extent that the Commission is superseding the trade option exemption and the Dodd-Frank Act comprehensively regulates trading in OTC swaps, these distinctions take on new and great significance. Although the Commission concludes that removal of the trade option exemption will have limited impact on market participants because of the swap end-user exemption, the regulatory requirements which would apply if these cash contracts are treated as though they are options would be enormous. First, characterizing these contracts as options would require compliance with all of the swap rules, including possibly requiring a natural gas producer whose only business is selling the physical product to register as a swap dealer. Moreover, APGA's members are "special entities" under section 4s of the Act, possibly

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[6] Section 1a(36) of the Act defines the term ''option'' as meaning, "an agreement, contract, or transaction that is of the character of, or is commonly known to the trade as, an ''option'', ''privilege'', ''indemnity'', ''bid'', ''offer'', ''put'', ''call'', ''advance guaranty'', or ''decline guaranty''.

[7] *RE: Defining the market: Entity and Product Classifications under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, Before the House Committee on Agriculture, 112th Cong. 1 (2011) (statement of Chairman Gary Gensler.)

[8] See e.g., "Exemption for Certain Contracts Involving Energy Products," 58 *Fed. Reg*. 21586 (April 20, 1993).

[9] See Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options," *supra*.

introducing an array of onerous requirements on utilities in carrying out very basic and uncomplicated cash market activities. Finding that natural gas swing contracts are swaps would interject an entirely inappropriate regulatory framework into transactions that the utility, the seller and the trade understand to be cash market transactions. This cannot have been Congress' intent in enacting the Dodd-Frank Act, as evidenced by its exclusion of nonfinancial deferred delivery contracts from the definition of "swaps."

In light of the very grave harm that uncertainty about the status of natural gas "swing" contracts may have for the utilities and their suppliers that use these and similar cash market transactions, APGA urges the Commission, when it adopts a new rule 32.4, to clarify that these contracts fall within the exclusion from "swaps" for deferred delivery contracts. Confirming that the current guidance on forward contracts applies to swaps is a good first step. But, the Commission must recognize that further guidance will be necessary, particularly with respect to supply contracts, such as natural gas "swing" contracts, that grant the purchaser the right to take varying amounts of the commodity at a variable (spot) price. Failure to provide such clarity will cause profound disruption to the cash markets and to the utilities that distribute natural gas to consumers across our Nation.

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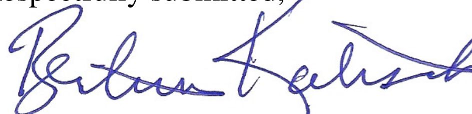
We would be happy to discuss our comments at greater length with the staff. Please feel free to contact Bert Kalisch, President and CEO of APGA, David Schryver, Executive Vice President at 202-464-2742, or Paul M. Architzel of Wilmer Cutler Pickering Hale and Dorr LLP, outside counsel to APGA, at 202-663-6240.

Respectfully submitted,



Bert Kalisch
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