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April 4, 2011

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

VIA ELECTRONIC MAIL

Re: *Commodity Options and Agriculture Swaps*

Dear Secretary Stawick:

I. INTRODUCTION.

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP respectfully submits this letter in response to the Commodity Futures Trading Commission (the "Commission" or "CFTC")'s request for comment concerning the Commission's Notice of Proposed Rulemaking on *Commodity Options and Agriculture Swaps* (the "Proposed Rule") published in the Federal Register on February 3, 2011.[1]

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial and residential consumers. Members of the Working Group are energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

[1] *See Commodity Options and Agriculture Swaps*, Notice of Proposed Rulemaking, 76 Fed. Reg. 6,095 (Feb. 3, 2011).

II. EXECUTIVE SUMMARY.

The Working Group appreciates the opportunity to participate in this proceeding and presents procedural and substantive concerns raised by the Proposed Rule's apparent intention to regulate physical options on physical commodities ("Physical Options") as "swaps" under Title VII of the Act. Physical Options, which are routinely transacted in multiple markets for physical energy commodities, should not be subject to regulation as swaps. The Working Group believes that regulating Physical Options as "swaps" would have a substantial negative effect on (i) markets for physical energy commodities, and (ii) participants in such markets that rely on physical energy commodities in the normal course of their business.

Because Physical Options contain an enforceable obligation to physically deliver a commodity, they are not presently viewed by commercial firms as "swaps." Exhibit A hereto contains several examples that illustrate certain Physical Options and other transactions with embedded optionality that are routinely transacted in physical energy markets but could potentially be subject to regulation as "swaps" under the Proposed Rule.

Procedurally, the Working Group respectfully requests that the Commission stay the instant proceeding until such time that the mandatory final rule further defining the term "swap" set forth in new Section 1a(47) of the Commodity Exchange Act ("CEA") is jointly issued by the Commission and the Securities Exchange Commission ("SEC"). Until the full scope and application of the definition of "swap" is known and understood, the Working Group is unable to fully evaluate the potential implications of the Proposed Rule, or comment meaningfully on how the proposed regulation of Physical Options could ultimately affect its members.

Substantively, notwithstanding the broad language of the statutory definition of "swap" in new CEA Section 1a(47), the Commission has sufficient authority to exempt Physical Options transacted in physical energy markets from regulation under the Act. The exclusion of Physical Options from regulation as "swaps" is consistent with the Congressional intent underlying the statutory exemption for physical-settling transactions set forth in CEA Section 1a(47)(B)(ii). Moreover, the Federal Energy Regulatory Commission ("FERC") and certain state regulators currently provide comprehensive oversight of Physical Options transacted in their respective wholesale, jurisdictional markets. Treating Physical Options transacted in such markets as "swaps" would create uncertainty and impose costly and duplicative regulatory requirements. Sections 722(e) and (f) of the Dodd Frank Wall Street Reform and Consumer Protection Act (the "Act"),[2] recognize this possibility and provide the Commission with ample authority to leave the current regulation of Physical Options transacted in markets subject to comprehensive FERC and state regulatory oversight undisturbed..

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[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

Further, the enactment of Title VII does not eliminate the policy basis for the Commission's adoption of the existing trade option exemption in current CFTC Rule 32.4. In Sections III.C and D, the Working Group argues that the Commission retain a trade option exemption and offers recommendations, including the supporting statutory and policy basis, for doing so. Finally, for the reasons discussed herein, the Working Group submits that Physical Options also should be excluded from the determination of whether any entity must register with the Commission as a swap dealer or major swap participant.

III. COMMENTS OF THE WORKING GROUP OF COMMERCIAL ENERGY FIRMS.

A. IN THE ABSENCE OF FINAL RULE DEFINING THE TERM "SWAP," THE PROPOSED RULE CANNOT BE PROPERLY EVALUATED.

The Proposed Rule seeks to amend, among other things, the Commission's current regulations for purposes of regulating physical options as "swaps," as that term is defined under new Section 1a(47)(A) of the CEA. Because the Commission and the SEC have yet to issue a final rule further defining the term "swap," as required by Section 712(d) of the Act, [3] the regulatory implications of the Proposed Rule cannot be fully evaluated or understood at this time.

Given the significant role that the term "swap" plays in the new framework for the regulation of over-the-counter derivatives markets under Title VII the Act, a final rule further defining this term will have a direct and material impact on the outcome of this proceeding. Furthermore, in the absence of a final rule further defining the term "swap," the Working Group is concerned that it will not have adequate notice and opportunity to meaningfully comment on how the Proposed Rule could ultimately effect its members' respective businesses.

For these reasons, the Working Group respectfully requests that the Commission stay this proceeding until such time that the joint final rule further defining the term "swap" is issued by the Commission and SEC, so that the full scope and application of that definition is known and understood. In the alternative, the Working Group requests that the Commission hold open the comment period on the Proposed Rule until market participants have had ample time to review the joint final rule further defining "swap." Such action will allow the Working Group and other affected market participants to submit fully informed comments as to the implications of the

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[3] On August 20, 2010, the Commission issued an advanced notice of proposed rulemaking seeking industry comment on, among other things, the definition of "swap," as set forth in new CEA Section 1a(47). *See Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, 75 Fed. Reg. 51,429 (Aug. 20, 2010) ("*Definition ANOPR*"). On September 20, 2010, the Working Group submitted comments in the *Definition ANOPR* proceeding addressing the definition of "swap."

Proposed Rule on their respective businesses.[4]

B. PHYSICAL OPTIONS ARE INTEGRAL TO THE OPERATION OF PHYSICAL ENERGY MARKETS AND SHOULD NOT BE REGULATED AS SWAPS.

Many market participants, including members of the Working Group, view options in two distinct contexts. First, there are Physical Options. These transactions are routinely executed in energy markets and involve an option to purchase or sell a physical commodity. The exercise of a Physical Option creates an enforceable delivery obligation requiring the parties to the transaction to make and take physical delivery of the underlying commodity. Second, there are financial options on a physical commodity ("Financial Options"). Financial Options are based on the value of an underlying physical commodity. The exercise of a Financial Option results in an exchange of cash between the counterparties. It does not trigger an enforceable obligation to make and take delivery of the underlying physical commodity.

Although Congress included Physical Options in the definition of "swap," it also vested the Commission with the statutory authority (discussed below) to regulate options, including Physical Options, in a manner different than swaps. The Working Group's members consider Physical Options as distinct from other "swaps," and more akin to physically-settled forward contracts, and believe that there are substantive policy reasons to treat these types of transactions in a similar manner. Regulating Physical Options as swaps under Title VII of the Act would have a substantial negative effect on not only the market for such options, but also more broadly on physical energy markets and participants in such markets that rely on physical energy commodities during their normal course of business.

Physical Options are an essential tool in markets for many physical energy commodities, including natural gas, power, crude oil, and other energy and energy-related products, that are used in a variety of ways. In addition, there are a number of types of transactions that are frequently executed in the physical energy markets that contain embedded optionality and could potentially be viewed as options on physical commodities. Set forth in Exhibit A hereto, the Working Group presents several examples of Physical Options, as well as examples of other transactions with embedded optionality that are not (and have not been) considered options in physical energy markets. The Working Group respectfully submits that the Physical Options and transactions that result in the physical delivery of energy commodities that contain an element of

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[4] In addition, the Working Group raised similar procedural concerns to those voiced above in comments filed with the Commission on December 2, 2010, addressing the notice of proposed rulemaking on position reports for physical commodity swaps. *See Position Reports for Physical Commodity Swaps*, RIN 3038-AD17, 75 Fed. Reg. 67,258 (Nov. 2, 2010).

embedded optionality, such as those include in Exhibit A, should not be subject to regulation as "swaps."[5]

The Proposed Rule fails to consider a number of serious operational and practical issues associated with regulating Physical Options as swaps.[6] The following points, which for illustrative purposes focus on daily call and put options[7] transacted in physical electricity markets, highlight some of these issues:

- How will such daily call and put options be treated by the Commission? Will they be treated as (i) swaps prior to the first exercise, and (ii) physical forwards after the first option is exercised?

- If a contract calls for a series of daily call or put options, will each option be considered a separate swap or will the whole series of options set out under the contract be considered a swap?

- If daily call or put options are deemed to be swaps, will standardized options be subject to the mandatory clearing requirement and will they be required to be traded on a swap execution facility or designated contract market (collectively, an "Exchange")?

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[5] The Working Group would also note that Chairman Gensler, in oral testimony before the House Agriculture Committee stated he believes that forward contracts with embedded options should not be regulated as swaps. *Defining the Market: Entity and Product Classifications Under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, House Committee on Agriculture, 112th Cong. (Mar. 31, 2011) (statement of Hon. Gary Gensler, Chairman, CFTC).

[6] The Working Group notes that the Proposed Rule leaves a number of open questions on the regulatory treatment of Physical Options that might be addressed in the proposed definition of "swap." The Working Group reserves the right to comment on those issues in that proceeding.

[7] Daily put and call options transacted in physical electricity markets provide the buyer of the option the right (but not an obligation) to (i) for a call option, to purchase and take delivery of a specified amount of a commodity from the seller, or (ii) for a put option, sell and deliver a specified amount of a commodity to the seller, through the daily exercising of the option during the term purchased. Generally, the option must be exercised no later than the business day prior to the day on which the applicable party desires delivery of the commodity. For example, consider a transaction where Party A sold a daily call option to Party B for 50 MWs of "around the clock" electricity (each hour during the 24 hours of a day) for each day during the month of May to be delivered to the Western Hub in PJM. Party B would have the right to exercise such option by notifying Party A on the business day prior to each calendar day in May on which it desires the delivery of 50 MW to the specified delivery point. For each day that the option is exercised during such month, the specified quantity of electricity will be delivered for such day. Typically 20 days following the close of the month of delivery, the Party B, the buyer, will pay Party A, the seller, the aggregate amount due for all deliveries made in a given month.

- Once a daily call or put option is exercised and becomes a forward contract, how does the Commission propose to handle the resulting physical delivery of electricity? Can an Exchange accommodate physical delivery of electricity? Or, upon the exercise of the option will the transaction be treated as a bilateral physical deal for regulatory purposes?

- If a counterparty to the daily call or put option was registered with the Commission as a swap dealer or major swap participant, how would capital and margin be applied to these transactions? Would any applicable margin requirements be (i) limited to the Commission-jurisdictional "option" aspect of the transaction, or (ii) bifurcated between the swap and physical forward aspects of the transaction?

- How would other federal or state regulators, such as the FERC or, for the Electric Reliability Council of Texas ("ERCOT"), the Public Utility Commission of Texas ("PUCT"), be affected if a daily call or put option is deemed to be a swap? How would it affect the ability of FERC and PUCT to perform their statutory obligations to provide regulatory oversight of the physical delivery of electricity in their respective jurisdictional electricity markets when the option is exercised? If the option is exercised within an organized, wholesale electricity market, how would the Proposed Rule affect the ability of the FERC or PUCT-approved market operator to administer such markets?

- How would the Commission's proposed rules for reporting swap transaction data apply to daily call and put options for physical electricity? Would market participants engaging in such transactions be required to report the option sale and premium or each exercise of an option?

Given Physical Options' operational and practical significance, the Working Group respectfully requests that the Commission address the types of issues identified above for all types of Physical Options in any final rule issued in this proceeding.

1. Consistent with Congressional Intent Underlying CEA Section 1a(47)(B)(ii), Physical Options Should Not Be Regulated As Swaps.

Exclusion of Physical Options from the definition of "swap" would be consistent with Congress' intent to exclude physically settled forward transactions from the definition of "swap" under new CEA Section 1a(47)(B)(ii) (the "Physical Delivery Exclusion"). Specifically, new CEA Section 1a(47)(B)(ii) excludes from such definition sales "of a nonfinancial commodity … for deferred shipment or delivery, so long as the transaction is intended to be physically settled." Though the language in the Physical Delivery Exclusion is similar to that of the current forward contract exclusion in CEA Section 1a(27),[8] Congress only intended that the Physical Delivery

[8] Both the Physical Delivery Exclusion and the forward contract exclusion contain the phrase "for deferred shipment or delivery."

Exclusion be interpreted "consistent with the forward contract exclusion that is in the Commodity Exchange Act."[9] The plain language of the Physical Delivery Exclusion is broad enough to include Physical Options and, interpreting this exclusion to cover Physical Options would be "consistent" with (i) the Commission's well-established and long-standing forward contract exclusion, and (ii) Congressional intent underlying new CEA Section 1a(47)(B)(ii) to exclude physically settled transactions from the definition of "swap."[10]

The Commission has long recognized the value and unique nature of Physical Options in commodity markets. Similar to physical forwards, parties entering into Physical Options intend that such options, when exercised, trigger an enforceable delivery obligation resulting in physical settlement. The policy rationale for excluding Physical Options from Commission oversight under the current "trade option exemption" in CFTC Rule 32.4 is very similar to that underlying the forward contract exclusion, which applies to "private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity."[11]

Congress, in promulgating the forward contract exclusion, and the Commission have recognized the unique role that bilaterally negotiated forward contracts between commercial entities that are capable of taking delivery of the underlying commodity transactions play in physical markets. In this regard, Physical Options where one party is able to take delivery of the referenced physical commodity play a similar role to physical delivery forwards in physical commodity markets, and like physical delivery forwards pose no risk to the financial system of the U.S.

Accordingly, the Working Group respectfully requests that the Commission exclude Physical Options from the definition of "swap" under new CEA Section 1a(47)(B)(ii).

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9 *See* Letter from Sen. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs and Sen. Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry to Rep. Frank, Chairman, Committee on Financial Services, and Rep. Peterson, Chairman, Committee on Agriculture (June 30, 2010).

10 Physical Options and physical forwards are both cost-efficient methods for managing commercial needs with regards to the supply of physical commodities. In addition, like physical forwards, Physical Options between commercial entities generally are not currently regulated as futures under the CEA. Specifically, privately negotiated Physical Options between eligible contract participants are currently exempt from most provisions of the CEA under 4c(b) of the CEA.

11 *See* Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39,188 (Sept. 25, 1990) at 39,190, reprinted at [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,925.

2. Current Regulation of Physical Options In Energy Markets Regulated by the Federal Energy Regulatory Commission and Certain State Regulators Should Not Be Disturbed.

Certain Physical Options executed in physical wholesale electricity and natural gas markets are already subject to comprehensive regulatory oversight provided by FERC and, in the case of ERCOT, the PUCT. Any additional regulation of Physical Options transacted in these markets by the Commission would, at best, be duplicative and unnecessary. At worst, it would cause significant regulatory uncertainty and disrupt the efficient operations of critically important energy markets.

Section 722(e) of the Act recognizes this possibility and recognizes FERC's and the PUCT's jurisdiction over any agreement, contract, or transaction that is entered into pursuant to a tariff or rate schedule approved by either regulator.[12] In FERC-jurisdictional wholesale electricity markets, for example, the Working Group notes that all sales of electric energy by public utilities must take place pursuant to the terms and conditions of a tariff or rate schedule approved pursuant Section 205 of the Federal Power Act ("FPA"), 16 U.S.C. § 824e. Because Physical Options and other types of physical transactions with embedded optionality in FERC-jurisdictional wholesale electricity markets require the ability to take and make delivery, they must be entered into by parties with approved tariffs. Further, all wholesale electricity sales executed in the ERCOT market must take place pursuant to tariffs, protocols or rate schedules approved by the PUCT.

The Working Group respectfully submits that the current, effective regulation of Physical Options transacted in FERC and PUCT-jurisdictional markets should not be disturbed by the Proposed Rule.[13] To the extent necessary and appropriate, Section 722(f) of Act provides the Commission with clear authority to act *sue sponte* and exempt from the requirements of the CEA

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[12] Section 722(e) of the Act states: "Nothing in this Act shall limit or affect any statutory authority of the Federal Energy Regulatory Commission or a State regulatory authority … with respect to an agreement…entered into pursuant to a tariff or rate schedule approved by the Federal Energy Regulatory Commission or a State regulatory authority and is—

''(I) not executed, traded, or cleared on a registered entity or trading facility; or

''(II) executed, traded, or cleared on a registered entity or trading facility owned or operated by a regional transmission organization or independent system operator."

[13] FERC possess nearly identical statutory authority to that of the Commission to prevent market manipulation in wholesale electricity and natural gas markets pursuant to Section FPA Section 222 and NGA Section 4A, respectively. Section 722(g) of the Act expressly preserves FERC's market manipulation authority under these provisions. This authority, when taken together with the Commission's enhanced anti-manipulation authority under new CEA Section 6(c) and the PUCT's anti-manipulation authority under PUCT Substantive Rule 25.503, should alleviate any concerns that the Commission may have regarding potential to address any market manipulation issues involving Physical Options left to FERC's and PUCT's regulatory oversight.

"any agreement, contract, or transaction" that is entered into under a FERC or PUCT-approved tariff, protocol or rate schedule if deemed to be "consistent with the public interest."[14] In light of the pervasive oversight currently provided by FERC and PUCT over Physical Options transacted in their respective jurisdictional markets, the Working Group believes that it is "consistent with the public interest" to exempt such Physical Options from CFTC oversight as a "swap." As noted above, such action would avoid (i) the imposition of costly and duplicative regulation of Physical Options, and (ii) creating uncertainty in these critically important energy markets. To the extent that the Commission has any concerns about the use of Physical Options to avoid CFTC jurisdiction, such concerns can be addressed in the memorandum of understanding required by Section 720 of the Act.

C. PHYSICAL OPTIONS BETWEEN COMMERCIAL ENTITIES SHOULD BE SUBJECT TO A MODIFIED "TRADE OPTION" EXEMPTION.

When the trading of options on commodities was banned in the 1970s, Congress and the CFTC provided the "trade option exemption" found in current CFTC Regulation 32.4. Trade options are defined as off-exchange options "offered by a person having a reasonable basis to believe that the option is offered to the categories of commercial users specified in the rule, where such commercial user is offered or enters into the transaction solely for purposes related to its business as such."[15] The trade option exemption was adopted based upon the premise that commercial entities had sufficient information concerning commodity markets and their transactions in commodity markets as they related to their business, so that application of the full range of regulatory requirements was unnecessary for business-related transactions in options on non- enumerated commodities.[16]

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[14] "If the Commission determines that the exemption would be consistent with the public interest and the purposes of this Act, the Commission shall…exempt from the requirements of this Act an agreement, … that is entered into—

> ''(A) pursuant to a tariff or rate schedule approved or permitted to take effect by the Federal Energy Regulatory Commission;
>
> ''(B) pursuant to a tariff or rate schedule establishing rates or charges for, or protocols governing, the sale of electric energy approved … by the regulatory authority of the State or municipality having jurisdiction to regulate rates and charges for the sale of electric energy within the State or municipality; or
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> ''(C) between entities described in section 201(f) of the Federal Power Act (16 U.S.C. 824(f)).''

[15] See, *Regulation and Fraud in Connection with Commodity and Commodity Option Transactions*, 41 Fed. Reg. 51,808 (Nov. 24, 1976) at 51,815.

[16] See, 41 Fed. Reg. 44,563, *Report of the Advisory Committee on Definition and Regulation of Market Instruments*, *Appendix A-4*, (Jan. 22, 1976).

The passage of the Act does not nullify the policy basis for the Commission's adoption of the existing "trade option exemption." Specifically, parties to options on physical commodities with an enforceable delivery obligation do not require the full panoply of regulatory protections available under the CEA and such transactions do not pose the same degree of risk to the U.S. financial system as other swaps. Moreover, since the "trade option exemption" is limited to transactions with sophisticated market participants like producers, processors, commercial users, or merchants, consumers and unsophisticated entities will not be exposed to potential market abuses. In short, retaining a trade option exemption in the form set forth below will not create a loop hole, it will allow important commercial transactions to be executed in an efficient manner. Accordingly, the Working Group requests that the Commission retain a trade option exemption in its regulations, and, below in Section III.C., offers recommendations as to how the Commission can do so. The Working Group suggests that the exemption read as follows:[17]

> "§ 32.4 Commodity option transactions; general authorization.
>
> (a) Subject to the provisions of this part, any person or group of persons may offer to enter into, enter into, confirm the execution of, maintain a position in, or otherwise conduct activity related to any transaction in interstate commerce that is a commodity option transaction, subject to all provisions of the Act, including any Commission rule, regulation, or order thereunder, otherwise applicable to any other swap.
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> (b) Except for the provisions of §§ 32.8 and 32.9, which shall in any event apply to all commodity option transactions, the provisions of this part shall not apply to a commodity option transacted with a person, or group of persons that is a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or by-products thereof, and that such producer, processor, commercial user or merchant enters into the commodity option transaction solely for purposes related to its business as such.
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> (c) The Commission may, by order, upon written request or upon its own motion, exempt any other person, either unconditionally or on a temporary or other conditional basis, from any provisions of this part, if it finds, in its discretion, that it would not be contrary to the public interest to grant such exemption."

[17] In drafting this modified trade option exclusion, the Working Group assumed that contracts that have an embedded option would generally not be considered a commodity option and, therefore, could not be regulated as a swap. Treating such contracts as commodity options under this trade option exemption would prevent wholesale electricity providers from entering into load serving agreements with commercial and industrial customers who are not eligible contract participants. Without access to load serving agreements, these customers will be limited in their ability to manage their energy needs.

D. STATUTORY MEANS FOR RETAINING A MODIFIED "TRADE OPTION" EXEMPTION.

1. The Commission Retains Authority to Regulate Commodity Options in a Different Manner than Swaps.

Although the definition of "swap" in Section 1(a)(47) of the CEA can be interpreted to include Physical Options, the Commission still retains the authority to regulate Physical Options under a separate regulatory regime. Section 4c(b) of the CEA states:

> "No person shall offer to enter into, enter into or confirm the execution of, any transaction involving any commodity regulated under this Act which 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", contrary to any rule, regulation, or order of the Commission prohibiting any such transaction **or allowing any such transaction under such terms and conditions as the Commission shall prescribe**. Any such order, rule, or regulation may be made only after notice and opportunity for hearing, **and the Commission may set different terms and conditions for different markets**" (*emphasis added*).

Under Section 4c(b), the Commission is permitted to promulgate an appropriate regulatory structure for each Physical Option market. The Proposed Rule expressly acknowledges this fact and cites the Commission's plenary authority to regulate options on commodities as the statutory authority under which it is proposing new Part 32 of the CFTC's Regulations.[18]

The Working Group urges the Commission to use its authority under Section 4c(b) of the CEA to retain a trade option exception in the form suggested above. When adopting the current trade option exemption, the Commission recognized that allowing commercial entities to use options on physical commodities in the normal course of their business does not create the opportunity for wide-spread fraud and allows such commercial entities to conduct their business operations in an efficient and cost effective manner.[19] Since that underlying rationale remains valid, the Working Group sees no reason the Commission should not continue to treat Physical Options entered into by a commercial entity as commercial transactions exempt from the majority of the provisions of the CEA.

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[18] *Proposed Rule* at 6,100.

[19] *See* notes 15 and 16 *supra*.

2. The Commission Can Also Exempt Commodity Options From the Definition of Swap Under Section 4(c) of the CEA.

The Working Group would also note that the Commission retains its general public interest exemptive authority under Section 4(c) of the CEA. The Commission states that "while section 4(c) was amended by the Act, for the purposes of this rulemaking its function and effect have not changed."[20] Section 4(c) allows the Commission to conditionally or unconditionally exempt any transactions from the provisions of the CEA in order to "promote responsible economic or financial innovation and fair competition."

The Working Group respectfully suggests that exempting Physical Options from the definition of "swap" under Section 4(c) would promote economic innovation. As discussed above, Physical Options play an integral role in a commercial energy firm's ability to manage the risk associated with its core business of delivering energy to customers. The Working Group requests that, if the Commission does not use its authority under Section 4c(b) of the CEA to exempt Physical Options from the definition of "swap," then it use its authority under Section 4(c) of the CEA to do so.

E. PHYSICAL OPTIONS SHOULD NOT BE INCLUDED IN ENTITY DEFINITION TESTS.

Physical Options transacted in energy markets should not be included in the determination of whether an entity is a swap dealer or major swap participant. As discussed above in Section III.B., treating Physical Options transacted in energy markets as swaps would raise a number of difficult regulatory and interpretational questions, and doing so would have a substantially negative affect on swap markets, while doing nothing to address systemic risk. Also, including Physical Options transacted in energy markets in the swap dealer and major swap participant determinations would add complexity to already complex tests. Accordingly, the Working Group requests that if the Commission elects to treat Physical Options like swaps, that it then exclude Physical Options transacted in energy markets from the swap dealer and major swap participant determinations.

F. COST BENEFIT ANALYSIS DOES NOT PROPERLY ASSESS COSTS.

Under Section 15(a) of the CEA the Commission has the obligation to consider and evaluate the costs and benefits associated with the Proposed Rule. The cost benefit discussion in the Proposed Rule does not satisfy this requirement. *First,* as noted above, the effect of the Proposed Rule cannot be properly considered or evaluated without a definition of "swap."

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[20] *See Proposed Rule* note 49 at 6,101.

Second, in analyzing the costs associated with the Proposed Rule, the Commission looks only to the costs associated with retaining the current regulatory structure and not the costs associated with removing the current regulatory structure, and does so in only three sentences.[21] The costs associated with retaining the current regulatory structure are properly characterized as potential benefits that would accrue to the swap markets if the Proposed Rule is adopted, not costs imposed by the Proposed Rule. The Commission has a statutory obligation to consider and evaluate the costs associated with the Proposed Rule.

Specifically, the Working Group respectfully requests that the Commission reissue the Proposed Rule after the definition of "swap" has been proposed with a cost benefit analysis that considers and evaluates the cost implications of removing the trade option exemption because, as discussed above, the Commission has the authority to retain such exemption. The costs considered by the Commission should include, but no be limited to, costs associated with reporting Physical Options in "real-time," subjecting Physical Options to mandatory central clearing and exchange trading, applicable recordkeeping requirements and applicable documentation standards.

G. GENERAL OPEN COMMENT PERIOD.

Given the complexity and interconnectedness of all of the rulemakings under Title VII of the Act, and given that the Act and the rules promulgated thereunder entirely restructure over-the-counter derivatives markets, the Working Group respectfully requests that the Commission hold open the comment period on all rules promulgated under Title VII of the Act until such time as each and every rule required to be promulgated has been proposed. Market participants will be able to consider the entire new market structure and the interconnection between all proposed rules when drafting comments on proposed rules. The resulting comprehensive comments will allow the Commission to better understand how their proposed rules will impact swap markets.

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[21] *Proposed Rule* at 6,105.

III. CONCLUSION.

The Working Group supports tailored regulation that brings transparency and stability to the swap markets in the United States. We appreciate the balance the Commission must strike between effective regulation and not hindering the uncleared energy-based swap markets. The Working Group offers its advice and experience to assist the Commission in implementing the Act. Please let us know if you have any questions or would like additional information.

Respectfully submitted,

/s/R. Michael Sweeney, Jr.______
R. Michael Sweeney, Jr.
David T. McIndoe
Mark W. Menezes

Counsel for the
Working Group of Commercial Energy Firms

EXHIBIT A

EXAMPLES OF PHYSICAL OPTIONS AND OTHER TRANSACTIONS WITH EMBEDDED OPTIONALITY IN ENERGY MARKETS.

The examples below include Physical Options and transactions that energy market participants do not historically consider options, but nonetheless contain an element of optionality. Transactions similar to the examples included below should not be regulated as swaps.

DAILY NATURAL GAS CALL

In a Daily Natural Gas Call Struck at First-of-Month Index, a commercial energy firm would agree to sell to a counterparty, such as a local natural gas distribution company ("LDC"), a specified quantity of natural gas on each day that the LDC elects to call on this gas, at a price equal to the First-of-Month Index for the month in which the delivery day falls. As part of this transaction, the LDC would agree to pay the commercial energy firm a specified sum per month regardless of the number of days during the month on which this option is exercised. Essentially, the LDC owns a daily call option on natural gas struck at the First-of-Month Index price, but this option can only be exercised by completing physical delivery of the natural gas where title to the gas is transferred from the commercial energy firm to the LDC.

WHOLESALE FULL REQUIREMENTS CONTRACT FOR POWER (CLEAN)

A wholesale full requirements contract for power provides a relevant example of a transaction with embedded optionality. Generally, pursuant to the terms of such a transaction, a commercial energy firm would agree to sell electric supply to a franchised, electric distribution company at a specified fixed price in an amount equal to all or a specified percentage of the electricity load requirements of the electric distribution company's customers. This transaction is considered a wholesale transaction subject to FERC regulation, but also the terms and final approval of the transaction can be subject to state public utility commission approval. Even though the commercial energy firm agrees to make physical delivery based on a future event, that event is actual usage of electricity by the distribution company's customers and results in physical delivery of electricity by the commercial energy firm to the distribution company. In addition, there is no premium or advance payment made by the electric distribution company for the right to call on the electricity. The commercial energy firm's compensation is strictly based on actual amounts of electricity delivered. Finally, the distribution company cannot exercise the right to call on the energy solely to achieve economic benefit and cannot compel financial settlement.

TOLLING AGREEMENTS IN ORGANIZED WHOLESALE ELECTRICITY MARKETS

Tolling transactions have become an integral part of the power market landscape because they provide a mechanism for one party, a Generator, to obtain a reliable, relatively fixed, long term revenue stream that can support bank financing and gives entity purchasing the output ("Toller"), a credit support mechanism for fuel sales to the plant. Generally, the most common form of tolling agreement in power markets involve gas-fired generation facilities. The Toller pays the Generator, *i.e.,* the owner and operator of the generation facility, a fixed payment for (i) the right to provide its natural gas to the Generator, (ii) have the Generator use the fuel to

generate power from the facility, and (iii) have the generator deliver the electrical output to the Toller for resale into an organized wholesale electricity market.

Pursuant to the terms of the tolling agreement, the Toller could be viewed as paying the Generator a fixed price over the life of the contract for a daily option to obtain the actual electrical output at a price that is contractually determined by the parties. The contract price for the actual output is usually based on the heat rate of the plant and its variable operating cost components. Typically there are operating conditions that determine the notice and time it takes for the electrical output to be delivered to the Toller.

These types of transactions allow Generators to hedge their natural long position in power markets as a means of obtaining a stable revenue stream and sometimes to satisfy lenders so that a project can be developed or satisfy the requirements of existing financing terms. The tolling structure allows the Toller paying the fixed price to provide fuel to the plant without credit exposure as there is no fuel sale to the generator owner. Rather, the Toller's fuel is simply converted to power, which the Toller can readily sell, without credit exposure, to in the regional, organized wholesale electricity market.

PHYSICAL DAILY HEAT RATE CALL OPTION

In a Physical Daily Heat Rate Call Option, a commercial energy firm with a generation asset would agree to sell to a load serving entity, such as a local utility ("Utility"), a specified quantity of power for the specified hours on each day that the Utility elects to call on this power, at a price equal to the product of the Heat Rate for the generation asset backing up of the sale and the gas price index for the relevant delivery day. As part of this transaction, the Utility would agree to pay the commercial energy firm a specified premium regardless of the number of hours during the month this option is exercised.

Essentially, the Utility owns a daily call option on power struck at a specific heat rate price, but this option, once exercised, is completed by the physical delivery of the power to a specified delivery point where title to the power is transferred from the commercial energy firm to the Utility. This kind of transaction allows a commercial energy firm to be paid more for the power from its generation asset by selling it (once exercised) as Firm (LD) Energy rather than unit contingent energy which would be include unit outage risk for the Utility if sold as a unit contingent option.

This does mean that the commercial energy firm needs to manage the outage risk of the unit itself but is in a better position to manage that risk than the Utility. The Utility now has access to power when the price for that power, as determined by the heat rate, is higher than the average heat rate for power available at that delivery point. The Utility has locked in a source of power at a specific heat rate. The lower the heat rate the more valuable the option is to the buyer. This transaction as described works as a hedge for both parties.

CAPACITY CONTRACT

Electric capacity markets place a commodity value on the availability of generation capacity separate from the value of electricity actually generated and sold. Capacity payments provide a mechanism for generation owners to recover fixed costs associated with new and existing facilities. Capacity markets also provide a mechanism for load serving entities and their regulators to ensure that an adequate supply of electricity is available to meet customer demand. In a traditional electric capacity transaction, one party will agree to pay a periodic fixed payment to another party in exchange for the right, but not the obligation, to compel the other party to schedule and deliver energy from a specified generation facility or pool of generating facilities, resulting in a sale of electricity from the capacity seller to the capacity buyer at a specified fixed price or at a floating price tied to a specified pricing formula or index.