SOUTHERN CALIFORNIA EDISON
An EDISON INTERNATIONAL Company

Pacific Gas and Electric Company

SDGE
A Sempra Energy utility

July 22, 2011

By Electronic Mail

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

RE: Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Proposed Rule 76 Fed. Reg. 29,818 (May 23, 2011)

File Number S7-16-11

RIN No. 3038-AD46

Dear Mr. Stawick:

In the comments that follow, Southern California Edison Company ("SCE"), Pacific Gas and Electric Company ("PG&E") and San Diego Gas and Electric Company ("SDG&E") (collectively, "California Utilities") respond to the Commodity Futures Trading Commission's ("CFTC") request for comment on the definition of "Swap" under the proposed Product Definition Rule of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[1]

Specifically, the California Utilities respond to the CFTC's questions 32 and 35 (quoted here in relevant part):

> 32. Should the forward contract exclusion from the swap definition apply to environmental commodities such as emission allowances, carbon offsets/credits, or renewable energy certificates?
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> 35. How would the proposed interpretive guidance set forth in this section affect full requirements contracts, capacity contracts, reserve sharing agreements, tolling agreements, energy management agreements and ancillary services? Do these agreements, contracts, or transactions have optionality as to delivery? If so, should they—or any other agreement,

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[1] In the Product Definition Rule, the Commissions request comment on proposed rules and interpretive guidance further defining "Swap," "Security-Based Swap," and "Security-Based Swap Agreement" in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). "Mixed Swaps; "Security-Based Swap Agreement Recordkeeping" as published on May 23, 2011 in the Federal Register ("Product Definition Rule") 76 Fed Reg. 29818 (May 23, 2011).

> contract, or transaction in a nonfinancial commodity that has optionality as to delivery—be excluded from the swap definition? [...] To what extent are any such agreements, contract, or transactions in the electrical industry regulated by [FERC], State regulatory authorities [...]?[2]

The California Utilities propose that the CFTC adopt rules implementing a definition of "Swap" that excludes: (a) Resource Adequacy ("RA") transactions, (b) Environmental Commodities (defined below), and (c) power purchase tolling agreements, which the California Utilities use to provide adequate electricity and system reliability for their customers.

The California Utilities utilize these products for the purpose of regulatory compliance and reliability of service on behalf of their customers. These products do not represent any risk to the stability of the United States financial system and are not the types of products intended to fall within the purview of the Dodd-Frank Act.

A. Introduction of the California Utilities.

SCE is an electric utility that provides electricity service to nearly 14 million people in central, coastal and southern California. SCE's business mission is the sale of electricity services to residential, commercial and industrial customers within its service territory. SCE owns and operates electric generation, transmission, and distribution facilities needed to supply energy to its customers, and is compensated for such service at rates regulated by the California Public Utilities Commission ("CPUC").[3] SCE engages in bona fide hedges solely for the mitigation of commercial risks relating to such service in order to provide a reliable and stable-priced electricity supply for its customers.

PG&E is a public utility operating in northern and central California and is wholly owned by PG&E Corporation, a holding company whose primary purpose is to hold interests in energy-based businesses. PG&E generates revenues mainly through the sale and delivery of electricity and natural gas to its ratepayers. PG&E is primarily regulated by the CPUC and the Federal Energy Regulatory Commission ("FERC"). The CPUC regulates utilities in the state of California, including electric power, telecommunications, natural gas and water companies.

SDG&E provides energy service to 3.5 million consumers through 1.4 million electric meters and more than 850,000 natural gas meters in San Diego and Southern Orange Counties. The utility's area spans 4,100 square miles. SDG&E is a subsidiary of Sempra Energy, a Fortune 500 energy services holding company based in San Diego. SDG&E's day-to-day-energy business is subject to regulation by the CPUC and FERC.

B. Summary of Comments

As a result of electricity deregulation in California, the California Utilities divested a large portion of their generation assets and now rely heavily on contracts with independent power producers to meet customers' electricity needs. These contracts include, but are not limited to, Resource Adequacy contracts,[4] power

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2 *Id.*

3 Additionally, the California Utilities' wholesale operations (including sales of electricity into the wholesale markets) are subject to regulation by the Federal Energy Regulatory Commission ("FERC").

4 The CPUC adopted a RA policy framework (PU Code section 380) in 2004 in order to ensure the reliability of electric service in California. The RA policy applies to all load serving entities (LSEs) within the CPUC's jurisdiction, including IOUs, energy service providers (ESPs), and community choice aggregators (CCAs).

purchase agreements with Qualifying Facilities and renewable energy resources, and tolling agreements.[5] In addition, the California Utilities also use a number of Environmental Commodities (defined below) in order to comply with Federal and California laws and the requirements of various air districts.

1. Resource Adequacy.

The first product – resource adequacy capacity – is a CPUC required regulatory product designed to ensure that sufficient physical generation capacity is available to the California Independent System Operator ("CAISO") to meet the needs of the electrical system. The California Utilities have RA agreements with third party suppliers that are designed particularly to meet resource adequacy goals established by the CPUC and implemented by CAISO. They are not permitted to enter such agreements except in accordance with plans approved by the CPUC, and their use of RA agreements is subject to monitoring and oversight by the CPUC and CAISO.

The California Utilities believe that RA agreements are not Swap transactions under the CFTC's Proposed Rule. These comments explain that the regulatory requirements under which RA agreements are entered into, and the commercial intent of the parties, both demonstrate that these agreements are excluded forward contracts for the availability of capacity to generate energy to be delivered under certain conditions. Because RA agreements are a unique and complex regulatory product, the California Utilities are concerned that the breadth of the proposed Product Definition Rule could cloud the regulatory status of RA agreements. The California Utilities therefore request that a final Product Definition Rule confirm that RA agreements are excluded forward delivery contracts and not Swaps. In the alternative, the California Utilities propose that the CFTC adopt procedural protections to protect the legitimate settled expectations of counterparties to RA agreements and to avoid interference with the complex regulated structure of California's Electric market.

2. Environmental Commodities.

The second category of products is a group of intangible commodities relating to environmental compliance and performance. These are not swaps, for three reasons. First, as explained below, these products are physically settled. They are "physical" within the meaning of existing CFTC regulations, and are "goods" within the meaning of the Uniform Commercial Code, and are consumed for compliance. Compliance requires delivery of the Environmental Commodity to the regulator; mere cash, which is the output of a swap, will not suffice. Second, the Dodd-Frank Section 750 Interagency Working Group concluded that carbon allowances are not swaps and are goods. Finally, declaring that Environmental Commodities are "swaps" notwithstanding the foregoing characteristics would assert a CFTC pre-emption of the state and federal environmental regulatory framework embodied in these programs.

In order to meet their legal commitments in connection with the production and procurement of electricity to serve their retail customers, the California Utilities transact in (a) limited licenses to emit a certain quantity of air pollutants, known as "Allowances," such as sulfur dioxide and nitrogen-oxide allowances traded under the Environmental Protection Agency's trading program under the Clean Air Act Amendments and allowances anticipated to be issued under California cap-and-trade program, (b) environmental attributes of generation from renewable resources (known as "RECs"), in order to demonstrate attainment of requisite procurement under the California Renewables Portfolio Standard, aspects of which are certificated by the Western Renewable Energy Generation Information System (WREGIS) and (c) traded greenhouse gas emission reductions, such as Carbon offsets ("VERs", for "voluntary emission reductions," collectively with Allowances, RECs and other types of emissions products such as, VOCs, emission reduction credits,

[5] A tolling agreement is a contract under which an entity pays a monthly fee ("capacity payment") to a power plant owned by another entity and in exchange obtains the right to dispatch and receive power from that facility when it provides fuel.

particulate matter emissions and various other emissions product used for compliance purposes, "Environmental Commodities"). The California Utilities believe that Environmental Commodities are "nonfinancial commodities" that are "physically delivered" within the meaning of Commodity Exchange Act §1a47, and request a final Product Definition Rule so confirming.

3. Tolling.

The third product is the exchange of fuel for energy and a "capacity payment" established in a Tolling Agreement ("TAs"). TAs are entered into by energy purchasing entities and specific generating units. TAs are settled by the physical delivery of fuel to the generating unit and the standing reserve of energy made available to the purchasing entity. TAs should not be treated as Swaps because they memorialize the physical exchange of one commodity for another. In form and function and for reasons set forth more fully below, TAs are more appropriately viewed as forward delivery contracts. In short, (i) TAs are bilateral contracts entered into to ensure the physical delivery of a commodity; (ii) TA delivery obligations are not contingent; and (iii), to the extent that pricing features change the price of energy delivered, they do not alter the fundamental character or purpose of the agreement of physical delivery of commodities. TAs should therefore be excluded from the statutory definition of Swaps.

The California Utilities offer these comments in the spirit of ensuring full compliance with the Dodd-Frank regulatory scheme – the achievement of which is predicated on the CFTC's application of the Product Definition Rule – and with the aim of protecting their shareholders and customers from unnecessary costs of regulatory uncertainty or unintended conflict between rules of the CPUC and the CFTC. [6] In considering these comments, the California Utilities ask the CFTC to bear in mind a general characteristic shared by the transactions addressed in this letter. Such arrangements are not fungible commodities suitable for clearinghouse treatment, instead they contain contract terms that are transaction-specific and highly negotiable, for example, terms that specify power plants, locations, or proximity to a particular fuel source.

C. California's Regulated Electric Power Markets.

1. Evolution of the Regulatory Framework.

The regulatory framework that governs California power markets has a unique history. California was a leader in the move to restructure electric power markets. The State instituted retail choice programs and a competitive market for the sale of wholesale power. It also required that operational control of the grid be administered by CAISO and made other arrangements to promote competitive market behavior, and vertically-integrated utilities separated generation from transmission and distribution and then divested much of that generation. Restructuring was anticipated to deliver to consumers the benefits of competition, including efficiencies to be realized through financial innovations that enabled trading in a variety of energy products. Such products were expected to enhance market liquidity, produce efficient pricing and dispatch, and provide accurate signals to induce efficient entry of generating capacity.

The California energy crisis of 2000-2001 tested the State's market design, and found it wanting. The crisis began in the summer of 2000 when, due to market inefficiencies Californians suffered rolling black-outs, financial markets for energy products were disrupted, and energy market participants such as SCE, PG&E and SDG&E endured extreme financial stress. Some load serving entities and merchant suppliers of electric power went bankrupt.

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[6] These comments are limited to issues raised by the Product Definition Rule not otherwise addressed in comments filed by the Edison Electric Institute (EEI) and the Energy Power Suppliers' Association (EPSA). In addition, California Utilities adopt and incorporate by reference the comments submitted to the Commissions by the Edison Electric Institute and Electric Power Supply Association (together, the "Joint Associations") in their comments to the Proposed Rule.

In immediate response to the crisis, the State stepped into the shoes of the financially distressed IOUs and negotiated long-term power purchase contracts. These contracts ultimately resulted in above-market prices and costly delivery terms. The CPUC thereafter undertook a comprehensive re-evaluation of the market design, which resulted in on-going efforts to accomplish reforms reflecting a more comprehensive approach to regulation of complex, interrelated markets for energy, reliability, capacity, congestion, support services, and commercial risks associated with delivery of energy to the State's consumers. The result was a series of regulatory reforms described, in relevant part, below.

2. California Assembly Bill 57 and Long Term Power Procurement.

The California Utilities' power procurement plans are governed by California Assembly Bill 57 ("AB 57").[7] Enacted in 2002, AB 57 was passed after the California electricity crisis of 2000-2001 in an effort to protect the California Utilities' customers from further financial harm associated with provision of electric service. AB 57 mandates that the California Utilities prepare Long Term Procurement Plans ("LTPPs") for review and approval by the CPUC. Transactions executed by an IOU must be in accordance with its approved LTPP (or reviewed for reasonableness by the CPUC), and costs associated with transactions that conform to an approved LTPP are recoverable through rates. To date, the CPUC has granted the California Utilities approval to engage in certain transaction types, including among other transactions: physical- and financially-settled spot and forward market purchases and sales of generation capacity, electricity, transmission, natural gas, pipeline capacity, storage and emissions products. Under the LTPP framework, the CPUC regulates the power-related procurement transactions activity of California IOUs.

The LTPP aligns the business interests of the California Utilities with those of customers by requiring the IOUs to procure energy under the principle of "least cost, best fit" (consistent with satisfaction of system reliability and environmental standards and goals) and reducing the risk of adverse impacts from commodity price volatility. To ensure that the interests of California consumers are protected, the CPUC reviews the California Utilities' LTPPs in advance, and, after the fact, evaluates whether power-related purchases and sales made pursuant to it are consistent with the procurement objectives it approved. The CPUC recognizes the important role played by financial commodity derivative products in the efficient functioning of commodity markets. It also appreciates that economically-appropriate hedging activity can reduce price volatility and enable IOUs to mitigate the commercial risks associated with commodity markets.[8] When it approves an LTPP, the CPUC places specific limits on the utility's participation in commodity derivatives markets.[9] The CPUC's review and approval of LTPPs and its review of power procurement transactions prevents potential harm to California consumers from speculative activity that could undermine the financial

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[7] A.B. 57, Cal. Pub. Util. Code § 454.5.

[8] California law mandates that the CPUC approve LTPPs that "moderate the price risk associated with serving [...] retail customers, including the price risk embedded in its long-term supply contracts," by authorizing an IOU to "enter into financial and other electricity-related product" contracts. *See* Cal. Pub. Util. Code § 454.5(b)(2). SCE's procurement plan must include all "electricity-related products," including swaps, that a utility intends to procure, describe the duration, timing and range of quantities of each product to be procured, analyze price risk arising from its particular portfolio of electricity-related products, and describe its "risk management policy, strategy, and practices." *See id.*; CPUC decision D.02-10-062 at 36. SCE must file a "risk report" with the CPUC monthly and the CPUC reviews that report to ensure that SCE complies with its LTPP. *See* CPUC D.04-12-048 at 170 (Dec. 12, 2004) ("The objective of the report is to show that the transactions entered into are in compliance with the upfront standards identified by the Commission."), available at http://docs.cpuc.ca.gov/word_pdf/FINAL_DECISION/43224.pdf.

[9] The CPUC monitors the types of financial contracts and takes action to protect California ratepayers. For example, the CPUC has specifically banned the use of CRRs, a product relating to congestion on transmission lines, from speculation, stating that they "should be used for hedging, not for financial speculation." CPUC Res E-4117 at 6-7 & n.11 ("SCE shall use LTCRRs as hedges against congestion costs and not for speculation [...] SCE should not obtain LTCRRs that are unrelated to SCE's sources of power."), available at http://docs.cpuc.ca.gov/WORD_PDF/FINAL_RESOLUTION/74083.PDF.

stability of the State's public utilities. Thus, the California Utilities already are subject to regulatory oversight designed to avoid or minimize financial risk, and such regulation is congruent with, and supportive of, the CFTC's mandate to reduce systemic financial risk. Importantly, the California Utilities earn no profits through their energy contracting activities, providing all services to customers at cost.

D. The CPUC's Resource Adequacy Program

The RA program is a central feature of California's regulated electric power markets. The RA policy framework – implemented as the RA program – guides generation capacity resource procurement and promotes infrastructure investment by requiring that Load Serving Entities ("LSEs") procure capacity to be made available to CAISO when and where needed. Each LSE is required to file a supply plan with the CPUC demonstrating that it has procured sufficient capacity resources (including reserves) needed to serve its aggregate system load on a monthly and yearly basis. Each LSE's system requirement is 100 percent of its peak-hourly forecast load plus a 15-17 percent reserve margin, for a total of 115-117 percent for each month. The RA program commits resources to deliver the contracted capacity at the direction of CAISO, so that day-ahead and real-time delivery obligations are controlled by CAISO, and not by the California Utilities or other LSEs. RA agreements enable an LSE to demonstrate compliance with RA program requirements.

The California Utilities are required by the CPUC to comply with all requirements of the RA program. To do so, each of the California Utilities must evaluate the portfolio of resources available to it for RA compliance. An LSE's RA supply portfolio includes natural gas-fired generators, nuclear power plants and renewable energy sources. The California Utilities supplement their physical assets with market supply of RA purchased bilaterally through the wholesale market. In addition to RA resources, each of the California Utilities uses a variety of physical and financial natural gas, electricity and transmission transactions to hedge its customers' price, supply and reliability exposure to risks arising from all components of the electricity supply process.

1. RA Agreements.

RA agreements are contracts for electric power generating capacity that possess specified system-wide RA attributes, local RA attributes and capacity attributes. Product attributes must comply with CAISO-determined capacity and reliability values and are otherwise subject to the terms of CAISO Tariff provisions that establish capacity availability standards. The California Utilities' RA agreements require generators to comply with CAISO tariff provisions for RA resource performance obligations, and such obligations are enforced by CAISO. Specifically, CAISO handles all scheduling, dispatch, pricing, payment and settlement activities.

The California Utilities' RA agreements put in place commercial commitments for a portfolio of generation resource capacity capable of meeting CAISO local and system-wide demand conditions. The operating characteristics, reliability attributes, environmental attributes and other features of the generation resource are specified in each agreement. The California Utility pays the seller a capacity price and is entitled to count the resource in RA compliance filings with the CPUC. The seller operates its unit in response to instructions from CAISO. The seller is entitled to revenues and is responsible for costs associated with services performed at the direction of CAISO.

All resources committed pursuant to an RA Agreement are subject to dispatch at the direction of CAISO. RA agreements do not confer on the California Utilities the right to the energy or ancillary services from a unit covered by such agreements. The California Utilities are entitled to re-sell all or a portion of the RA product, and in the event a centralized capacity market develops within the CAISO region, the California

Utilities would have the exclusive right to "offer, bid or otherwise submit" the contracted capacity for re-sale in such a centralized market.

2. Analysis.

The purpose of RA agreements is to ensure that sufficient power generation resources are available to serve the needs of California consumers, as those needs are established by the CPUC. An RA Agreement provides the California Utilities with the right to count the generation resource associated with the agreement as an asset that is committed to meet the IOU's compliance filing requirements with the CPUC. Thus, RA agreements are most appropriately characterized as contracts for future delivery of a product pursuant to state regulatory requirements. RA agreements are outside the scope of the statutory definition of a Swap because they are excluded forward contracts for delivery of a commodity.

The "facts and circumstances" created by the regulatory features of an RA product provide a strong demonstration of the intent to settle physically, even though actual delivery remains contingent until CAISO matches resource attributes with real-time demand. The California Utilities cannot control the availability of resources or whether the agreements settle physically, because CAISO has complete control over whether to run a power plant within its control area. RA agreements would not exist at all but for CPUC/CAISO requirements to ensure adequate, reliable physical capacity to meet anticipated conditions on the transmission grid. In short, RA agreements are designed primarily to ensure electric grid reliability and physical performance.

In the Product Definition Rule, the CFTC indicates that it will assess the parties' expectations and intent at the time the transaction was executed in order to determine whether a transaction is an excluded forward delivery contract. The regulatory features of the RA program provide strong documentation of the intent to deliver and to settle physically. In addition, to the extent the RAs may be viewed as forward contracts that contain embedded commodity options, such options do not undermine their predominant function: to ensure physical delivery from a contracted resources if and when capacity and load can be matched.

The regulatory framework in which RA agreements have a place creates a more flexible form of forward contract that delivers to consumers the benefits of efficient hedging in energy capacity markets. This regulatory framework serves the important public policy goal of avoiding systemic risk within the markets regulated by the CPUC. In the absence of an RA program subject to CPUC/CAISO oversight, an unregulated market might develop a variety of products used to ensure delivery, some of which could be deemed to be Swaps. However, each RA agreement provides contractual assurance of the availability of power generation capacity to be delivered as needed according to the dictates of CAISO. Thus, RA agreements differ from the kind of financial products deemed to be "energy swaps" under the terms of the Dodd-Frank Act.

E. The California Utilities' Use of Environmental Commodities in the State of California

The California Utilities engage in Environmental Commodities transactions in connection with the production and procurement of electricity to serve retail load. Specifically, they acquire emissions allowances from state or federal programs; they transact both in RECs that are either bundled with or unbundled from energy an are accounted in Western Renewable Energy Generation Information System ("WREGIS") as WREGIS Certificates pursuant to the California Renewables Portfolio Standard ("RPS")). Additionally, the California Utilities shortly expect to transact in both Carbon offsets and allowances (each of which are subject to different sets of rules) issued by the California Air Resources Board ("CARB") pursuant to cap and trade regulations promulgated under the California Global Warming Solutions Act.

Each of these Environmental Commodities can be bought and sold on a spot basis for cash, as well as forward for future delivery. RECs are indelibly tied to the production of renewable energy and are not created until that energy has been generated. Each California Utility must purchase bundled renewable energy or RECs in order to meet the goals of California's RPS. All eligible renewable transactions require WREGIS accounting.[10] A California Utility can sell a REC, or use it for compliance with the RPS by retiring the WREGIS Certificate associated with that REC. The retirement is an example of a physical delivery; before retiring the WREGIS Certificate, a California Utility owned it and could do with it as it wished. Once retired, the California Utility no longer has it. A California Utility cannot simply deliver a cash settlement payment in lieu of the actual WREGIS Certificate. Even though the WREGIS Certificate is an intangible right on an electronic registry, it is not cash, and cash is not delivered for compliance. The WREGIS system does not handle cash.

The same is true for compliance offsets and allowances. When a California Utility buys an emission allowance or a REC, it pays money and receives something other than money in return. What it receives is eventually consumed through retirement for compliance with a mandatory or voluntary program. This means that these instruments are not swaps, but rather largely intangible commodities that are physically settled.

1. Environmental Commodities Are "Physically" Settled Under the CFTC's Current Meaning of "Physical".

CFTC Regulation 1.3(II) "defines the term 'physical' as 'any good, article, service, right or interest upon which a commodity option may be traded in accordance with the Act and these regulations.'"[11] As options on Environmental Commodities may be traded in accordance with the Commodity Exchange Act, Environmental Commodities themselves clearly fit within this definition of "physical" and their exchange would therefore be "physically settled" under current CFTC definitions

RECs and other Environmental Commodities are very different from the "non-physical commodities," such as interest rates or temperatures that the CFTC references in its adaptation NOPR.[12] These latter are macroeconomic and atmospheric indicators. One can move and physically transfer a REC or emissions allowance or offset from one account to another, but it is not possible to move and physically transfer an interest rate or a temperature reading. Moreover, RECs, unlike interest rates or temperatures, are only created by (and are associated with) the production of energy from a specific source.

2. The Interagency Working Group Concluded Carbon Allowances are Not Swaps and Are Not Subject to Dodd-Frank.

The Interagency Working Group for the Study on Oversight of Carbon Markets tasked under Section 750 of Dodd-Frank with conducting a "study on the oversight of existing and prospective carbon markets to ensure an efficient, secure, and transparent carbon market, including oversight of spot markets and derivative markets" published its Report on the Oversight of Existing and Prospective Carbon Markets[13] on January18, 2011 ("Study"). The Interagency Working Group included designees of two Cabinet Secretaries, the Chairmen of the CFTC, SEC, and FERC, the Administrator of the EPA, and the Commissioner of the Federal Trade Commission.

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[10] E.g., California Energy Commission, Renewables Portfolio Standard Eligibility Commission Handbook (4th Edition); Western Renewable Generation Information System Operating Rules available at http://www.wregis.org/uploads/files/73/20070704_WREGIS_Operating_Rules_1v1_Final.doc.

[11] Adaptation NOPR, FR 33068 col. 3.

[12] Adaptation NOPR, FR 33069 col. 2.

[13] Available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy_carbon_011811.pdf.

The Study concluded that Carbon allowances were not within the purview of authority granted to the CFTC under Dodd-Frank. The Study calls for oversight of carbon markets, but stated "absent specific action by Congress, neither the CFTC nor any other federal agency may have any authority to routinely monitor trading in the secondary markets or to create rules or regulations that would apply to these markets."[14] "With respect to the carbon derivatives market, to a large extent, once the provisions of the Dodd-Frank Act become effective in July 2011, comprehensive oversight of carbon derivative products, whether traded on an exchange or OTC, will be achieved. However, primary and secondary carbon allowance and offset markets will not be subject to the same comprehensive oversight as derivative markets."[15] By concluding Dodd-Frank was inapplicable to them, the Study necessarily concluded that carbon allowances are not swaps.

Uniform Commercial Code §2105(1) defines as a "good" any thing that can be moved other than money. Environmental Commodities are things that can be moved, even if they are intangible. The Study agrees: "unless policymakers choose to differentiate them, allowances are a perfectly homogenous good."[16]

3. The CFTC Should Not Pre-Empt State and Federal Environmental and State Public Utility Regulators.

The CFTC asks "Would application of the forward contract exclusion to ... environmental commodities permit transactions that should be subject to the swap regulatory regime to fall outside the Dodd-Frank Act?"[17] If Environmental Commodities are not "swaps" within the meaning of the statute, they are not subject to the swap regulatory regime, and are outside the Dodd-Frank Act pursuant to the terms of the Dodd-Frank Act itself; they have not "escaped" or "been permitted" to fall outside the boundaries of the Dodd-Frank Act.

The CFTC proposes to expand its jurisdiction to cover Environmental Commodities by defining the commodity itself as a swap, and by modifying the definition of "physical" so that any intangible commodity can be claimed to be under the CFTC's jurisdiction.[18] Were it to do so, the CFTC would pre-empt the regulatory schemes set by EPA and state environmental and energy regulators for the benefit of the environment and ratepayers. The Dodd-Frank Act was not written to make it more difficult for the regulators with primary jurisdiction over programs establishing allowances, such as the EPA and CPUC, to protect the environment and to otherwise implement and carry out the purposes of their programs.

4. Declaring Environmental Commodities to be Swaps Would Un-Level the Playing Field in State and Federal Compliance Programs.

a. In Secondary Transactions in Federal Programs.

Commodity Exchange Act §1a47(B) says "[t]he term 'swap' does not include: (ix) any agreement, contract, or transaction a counterparty of which is ... the Federal Government, or a Federal agency that is expressly backed by the full faith and credit of the United States ... ." In the Clean Air Act Amendments cap-and-trade program. EPA Allowances are issued in a transaction with a Federal agency- namely, the Environmental Protection Agency. For EPA-issued Allowances to be "swaps," they could only become swaps in a resale after they had been received from the EPA. Designating only resold Allowances as swaps would distinguish EPA Allowances on the basis of the identity of the immediately succeeding owner in a transaction, and such a designation would clearly be on a basis that is different from either the nature of the item that is the subject of the transaction or the manner in which the item is "physically settled."

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14 Study, p. 43.
15 Study, p. 53 (emphasis supplied).
16 Study, p. 31.
17 Swap Definition NOPR, FR 29867 col. 3.
18 Adaptation NOPR, FR 33069 col. 2.

F. Tolling Agreements

1. Characteristics of Tolling Agreements.

Tolling Agreements ("TAs") provide a purchasing entity the right to the capacity, energy, ancillary services and any other product derived from a specified generating unit, all based upon a delivered fuel price and an agreed heat rate.[19] They are unit specific arrangements that grant the purchasing entity an amount of the output of the plant, with the plant operator obliged to deliver pursuant to scheduling instructions by the purchaser. Under many tolling arrangements the purchasing entity serves as the fuel manager with responsibility for procurement of the unit's fuel needs, but it does not actually operate the unit. The purchasing entity schedules the fuel to the plant and directs the unit how often and at what level to run. Payments for the plant output are made two-fold, the first is the "capacity payment" which is essentially a lease payment (much like leasing a car), it is a payment for the right to use the unit (e.g., the car, how and whenever the lessor chooses); the second is a variable payment which includes fuel delivery that is based on the efficiency of the generation plant (e.g., the lessor of the car pays for the fuel the car uses – if the car is inefficient the lessor pays more, if the car is more efficient the lessor pays less) as well as payment to reflect operation and maintenance cost the unit incurs when running.

TAs are all individually designed, but most TAs will fall into two general categories. In addition to the capacity payment and operating expenses (which apply according to the specific contract), when the power purchaser needs power, the purchaser will schedule the specific generating unit, and either:

> (1) the purchaser delivers fuel to a power generation plant and in exchange, the power generator delivers energy from the unit to the power grid on behalf of the purchaser. In this instance, payment is based on a contractually-agreed heat rate for the designated plant;[20] or
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> (2) the generator delivers energy from a designated unit based upon the indexed price of natural gas or other fuel, which is then multiplied by a contractually-agreed heat rate to achieve a price. In this instance the power purchaser does not have an obligation to actually deliver the fuel that is physically consumed within the plant.

The predominant features of TAs are those of forward contracts that are excluded from the statutory definition. TAs cannot be characterized as Swaps under the statutory definition because they entail the physical exchange of one commodity for another. TAs should also be viewed as excluded forward delivery contracts because:

(a) TAs serve the same purpose as forward contracts – to make commercial arrangements for physical delivery of electric power and related services on behalf of customers.
(b) TAs provide the purchasing entity with the right to require delivery in response to actual demand from its customers.
(c) The purchasing entity has the role of scheduling coordinator and fuel manager to ensure that energy and related services are performed in a manner that meets the physical requirements of its customers in a commercially reasonable, reliable and financially sound manner.
(d) TAs have characteristics of a lease, in that the purchasing entity obtains the exclusive right to the use of the plant during the term of the agreement. A TA enables a purchasing entity to have the benefits of ownership of a power plant without the capital investment required to develop, construct, maintain and operate the plant.

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[19] A heat rate represents the efficiency at which the generating unit can convert fuel into power.

The California Utilities submit that TAs should not be treated as Swaps under Title VII of the Dodd-Frank Act. They serve the routine commercial purpose of assuring physical delivery of the commodity – electric power – that the purchasing entities are in business to provide. Delivery obligations under a TA are not contingent. Rather, the unit must deliver in accordance with instructions from schedulers for the purchasing entity. Finally, to the extent TAs may encompass heat rate conversion or other pricing features that are derived from the value of a commodity, such provisions affect only the price of energy delivered. They do not alter the fundamental character or purpose of the agreement to require delivery of electric power.

The California Utilities respectfully request that the CFTC remove regulatory uncertainty associated with TAs by confirming that TAs are excluded forward contracts. The California Utilities further request the CFTC to provide them with the procedural protections to preserve the legitimate settled expectations of parties to existing TAs and to ensure that regulatory uncertainty does not prompt market participants to abandon or limit use of TA arrangements which afford purchasing entities with important efficiencies and the flexibility to manage their commercial risks.

The California Utilities appreciate the opportunity to provide the foregoing comments.

Respectfully submitted,

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