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David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 *Fed. Reg.* 29818 (May 23, 2011), RIN 3235-AL14, SEC File No. S7-16-11

Dear Mr. Stawick:

We are submitting these comments on behalf of our client, ONEOK, Inc. ("ONEOK"). We and ONEOK appreciate the opportunity to submit our views to the Commodity Futures Trading Commission ("CFTC" or "Commission") on the Notice of Proposed Rulemaking entitled, "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping," 76 *Fed. Reg.* 29818 (May 23, 2011) ("Notice"). The Notice, proposed jointly with the Securities and Exchange Commission ("SEC"),[1] further discusses the definition of "swap" in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[2] in the context of non-financial contracts for deferred delivery.

ONEOK

ONEOK is a diversified energy company that has three business units: Distribution, ONEOK Partners, L.P., and Energy Services. ONEOK's Distribution segment is comprised of three natural gas local distribution companies that serve over two million customers in Oklahoma, Kansas, and Texas. Retail natural gas sales are carried out by the ONEOK Energy Marketing Company segment ("OEMC").

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[1] This comment addresses the definition of "swap" in the context of nonfinancial commodities and is therefore being submitted only to the CFTC.

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

ONEOK is the sole general partner and owns 42.8% of ONEOK Partners, L.P., a publically traded master limited partnership engaged in natural gas gathering and processing, natural gas pipelines and storage, and natural gas liquids.

ONEOK's energy services business is engaged in providing premium natural gas wholesale marketing services to its customers across the United States. The wholesale gas marketing services are provided by ONEOK Energy Services Company, L.P. ("OES"), a wholly-owned subsidiary of ONEOK. OES engages in the physical marketing and delivery of natural gas and bundled services throughout the United States and Canada.

Among the contracts that OES offers to its customers, which include local distribution companies ("LDCs"),[3] electric utilities, and commercial and industrial end users, are contracts known to the trade as "swing" or "peaking" natural gas contracts. In addition, OEMC offers to its retail customers "full requirements" contracts. As discussed in greater detail below, all of these contracts are forms of a commercial merchandizing contract and are integral to the supply of natural gas to these customers.

Forward Contracts with Variable Delivery Amounts

Section 1a(47)(A)(i) of the Commodity Exchange Act, 7 U.S.C. §1 et.seq. ("Act") defines a swap, in part, as an "option of any kind that is for the purchase or sale, or based on the value, of . . . commodities ...."[4] Section 1a(47)(B)(ii) of the Act excludes from this definition, "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."

In distinguishing commodity options that are subject to regulation as "swaps" from instruments within the exclusion for forward contracts for nonfinancial commodities and therefore not regulated as "swaps," the Commission explained that it would look to the "specific facts and circumstances of the transaction as a whole to evaluate whether any embedded optionality operates on the price or delivery term of the contract, and whether an embedded commodity option is marketed or traded separately from the underlying contract, to determine whether that transaction qualifies for the forward contract exclusion from the swap definition for nonfinancial commodities."[5] The Commission further reasoned that:

> [A] forward contract that contains an embedded commodity option or options would be considered an excluded nonfinancial commodity forward contract (and not a swap) if the embedded option(s): (i) May be used to adjust the forward contract price . . . (ii) do not

[3] LDCs are regulated utilities involved in the delivery of natural gas to consumers within a specific geographic area.

[4] 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.'"

[5] The CFTC notes that it views this analysis as an application of the "two-step analysis" of embedded options utilized in the *In re Wright*, CFTC Docket No. 97–02, 2010 WL 4388247 at *3 (CFTC Oct. 25, 2010).

target the delivery term, so that the predominant feature of the contract is actual delivery; and (iii) cannot be severed.[6]

The Commission's analysis in the Notice with respect to the scope of the forward contract exclusion for swaps on nonfinancial commodities rests primarily upon a long-standing interpretation of the Commission's Office of the General Counsel ("OGC Interpretation").[7] The OGC Interpretation distinguishes forward contracts from "trade" options on agricultural commodities. That interpretation, however, is based upon a limited number of examples of agricultural contracts.

In light of the wide range of cash market and commercial merchandizing contracting practices in which delivery terms and amounts may vary and the importance of these practices and contractual terms to the Nation's economy, the Commission should offer additional guidance that would be helpful in distinguishing such forward contracts from options that are within the definition of "swap" under the Act.

Contracts that permit variable delivery amounts are not necessarily commodity options

The beginning point in analyzing such contracts must be whether the contract is an option or contains an embedded option. As the OGC Interpretation notes, "to determine whether an instrument is an option, the Commission and the courts have examined pre-existing contract law, commercial practice and the economic nature of the contract."[8] The OGC Interpretation states that the economic reality of an option is that

> an option is a limited risk instrument. That is, the option purchaser is not liable for payment resulting from any adverse price movement of the commodity underlying the option. Rather, the option purchaser will benefit from a favorable price move and will not be liable for any other losses beyond the premium or other payment that the purchaser pays for the option.[9]

In discussing the example of an agricultural trade option, the OGC Interpretation closely ties the choice by the purchaser of the option on whether to deliver to the price level of the commodity. The OGC Interpretation explains that in a trade option, "in return for the premium, the producer has the right to require the merchant to accept delivery of and pay a minimum contract price for the crop. However, the producer may forfeit the premium and seek a higher price for and deliver the crop elsewhere."[10] Thus, the OGC Interpretation's focus on delivery is the right of the

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[6] "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping," 76 *Fed. Reg.* 29818 at 29830 (May 23, 2011) ("Notice").

[7] "Characteristics Distinguishing Cash and Forward Contracts and 'Trade' Options," 50 *Fed. Reg.* 39656 (September 30, 1985).

[8] *Id.* at 39658.

[9] *Id.*

[10] *Id.* at 39660.

producer to walk away from its delivery obligation *in order to obtain a higher price* by selling the commodity to another. In this context, it is reasonable to assume, as does the Notice, that "where the embedded option(s) render delivery optional, the predominant feature of the contract cannot be actual delivery and therefore the embedded option(s) to not deliver preclude treatment of the contract as a forward contract."[11] In that case, the optional nature of delivery provides the option purchaser with a means of financially protecting itself from changes in the value of the commodity.

However, not all contracts in which the amount to be delivered can vary are primarily intended to operate as financial options. As discussed below, traditional contract law also recognizes that contracts for deferred delivery can vary in the amount taken under the contract without altering the fact that the parties primarily intend to use such contracts as a means of assuring supplies of a physical commodity. The Commission recognizes in Question Number 35 that these contracts take many forms. Question 35 asks:

> 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, contract, or transaction in a nonfinancial commodity that has optionality as to delivery—be excluded from the swap definition? If so, please provide a detailed analysis of such agreements, contracts, or transactions and how they can be distinguished from options that are to be regulated as swaps pursuant to the Dodd-Frank Act.[12]

ONEOK's Contracts

ONEOK, through its wholesale gas marketing subsidiary OES, offers its customers a number of types of contracts for delivery of natural gas under which the amount called for delivery may vary. In each of these types of contracts, although the amount of natural gas delivered may vary, both parties intend the contracts to result in delivery of the commodity, *as needed.* The purpose of these contracts is to ensure OES's customers, most of which are gas or electric utilities, of an adequate supply of natural gas regardless of day-to-day changes in demand that may be caused by variation in weather, operational considerations, or other factors.

Gas utilities typically build a portfolio of different types of gas supply contracts in order to reliably meet their customer demands throughout the year. As part of this process, the utility will usually consider the amount of gas normally needed year-round (referred to as the base load), the amount needed during normal winter months, and the amount normally needed on the

[11] 76 *Fed. Reg.* at 29830.

[12] *Id.* at 29832.

coldest days (referred to as "peaking" or "swing" supplies). The latter is usually the most difficult to predict because of weather uncertainties.[13]

The individual and specific needs of utilities and other variable-need customers require the offering of premium service gas contracts. Therefore, OES offers premium service contracts to help the customer ensure that it will have a reliable gas supply when, and to the extent, needed to meet its demand. For example, OES may enter into a contract with a customer under which OES is obligated to deliver as much natural gas as the customer needs at a specific location within agreed upon parameters.[14] The actual amount of gas delivered may vary depending upon weather or some other variable. This kind of contract is a tool available for customers that need supply only during a "swing" or "peak" period during which its gas demands exceed the normal base load supply level.

The terms of the contract are either individually negotiated with the customer or the result of a Request for Proposal ("RFP") process, and the daily volume, notification times, term, location, callable service rights (e.g. weekend uniformity, next day or same day rights, daily or term load factors, if any) would vary depending upon the customer's individual service needs.[15] The term of the contract generally would extend for a number of months over the entire heating season with multiple delivery opportunities, perhaps, as frequently as daily. The price of natural gas taken under the contract may be fixed at the time the contract is entered, or more likely, it may be adjusted periodically or at the time of delivery with reference to the spot price of a specified monthly cash index. Other provisions typically found in a gas supply contract include identification of the receipt and delivery points, imbalance and penalty provisions, force majeure, title, possession and control of the gas, all of which are characteristic features of a traditional forward contract for natural gas.

Although ONEOK's premium service contracts, such as the requirements, swing or peaking contracts, provide the customer with the ability to take a varying amount of natural gas under the contract, the primary purpose of the contract is not to provide the customer with one-way price protection, as is the economic purpose of an option. This is especially apparent in those contracts in which the price periodically is adjusted. Clearly, the purpose of these contracts, whether for a fixed or floating price, is to defer delivery of the commodity for the

[13] These same considerations may also be relevant to electric utilities and large industrial customers when determining their gas supply contract needs throughout the year.

[14] Such contracts may include a band within which the customer may specify the amount to be delivered. The contract may specify a minimum and maximum amount that can be taken or simply a maximum amount. Customers may maintain a portfolio of such contracts from different suppliers and may vary the amount that they take on any particular contract, or mix of contracts, based upon a number of factors, including price. As a whole, however, the customer's portfolio of contracts is intended primarily as a means of assuring that natural gas is delivered in the amounts needed by the customer.

[15] Customers may use a RFP process to solicit interest by suppliers, like OES. OES works directly with our customers when there is no RFP. There are a number of customers that routinely negotiate directly with OES regarding their product needs. OES typically submits a written response to the customer; although, some customers utilize an on-line platform, such as Trumark or World Energy, where OES would provide its offer in a reverse auction format.

commercial convenience of the parties, as is characteristic of traditional forward contracts. Although the amount delivered to the customer may vary, the primary purpose of the contracts is to assure a reliable supply of the commodity when, and in the amount, needed.

The intent of the parties to defer delivery of a varying amount can be ascertained based on objective criteria, such as the pattern of deliveries in relation to variation in weather, customer demand, or other similar factors. The contracts unquestionably serve a commercial purpose by filling the intermediate space between owning a less expensive base load supply (flat, uniform daily delivery requirement) and the more expensive storage injection and withdrawal rights for the physical commodity. These contracts are essential to ONEOK's customers because they need to be able to access firm physical supplies in order to address changing daily load requirements. Accordingly, ONEOK's customers enter into such contracts not primarily as a means of financially hedging or transferring financial risk, but rather as a means of purchasing, for deferred delivery, the amount of physical natural gas needed in order to hedge supply risk.

Full Requirements Contracts

In addition to the premium contracts discussed above, ONEOK, through its OEMC segment, offers retail customers "full requirements contracts." A full requirements contract, another form of contract in which the amount that is delivered can vary, is a well-established concept in contract law. In a requirements contract, the purchaser may vary the amount that it takes in delivery on the contract but deals exclusively with one supplier. Although the purchaser may vary the amount that it takes in delivery, the amount is based upon an objective need. As the Uniform Commercial Code provides, the buyer has an obligation to act in good faith with respect to the varying amount that is called for delivery. As noted in Corbin on Contracts, in a requirements contract:

> [T]he quantity term is not fixed at the time of contracting. The parties agree that the quantity will be the buyer's needs or requirements of a specific commodity or service. Requirements contracts serve a vital commercial need. The buyer gets the assurance of a source of supply. The supplier locks in a customer, knowing, however that the customer's needs are variable and uncertain .... *This is not to say that a requirements contract is a mere option contract....* [A] requirements buyer is privileged not to buy. Nevertheless, the buyer's promise is not illusory .... The promisor's duty is conditional upon the existence of an *objective need* for the commodity or the service .... [16] (Emphasis added).

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[16] *Corbin on Contracts* § 6.5 at 240-53 (1995). *See also, Uniform Commercial Code* § 2-306, defining a requirements contract, noting that:

> (1) A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.

Effect of Notice

For the reasons discussed above, these contracts, based upon pre-existing contract law, commercial practice, and their economic nature, are forward contracts—not options—and are within the forward contract exclusion from the definition of "swap." However, the interpretation in the Notice does not provide sufficient legal certainty that these contracts are within the forward contract exclusion. Without greater certainty, commercial entities in the energy sector will likely face unnecessary market disruption and find their ability to enter into such contracts chilled, with little or no regulatory benefit.

The types of contracts described above are distinguishable from the contracts described by the Commission as forward contracts with embedded options. Although the amounts that can be taken on delivery may vary, the primary intent of the contracts is not to provide price protection, which is clearly the intent of the contracts described in the OGC Interpretation as trade options. Rather, the primary intent of the contracts, described above, is to effect deliveries which have been deferred, for commercial convenience, in an amount as needed by the customer to meet changing daily load requirements. This intent can be inferred from objective criteria, including the terms of the contracts and the practice of the contracting parties. Moreover, this analysis is supported by traditional contract law, which recognizes the distinction between requirements contracts and options.

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ONEOK appreciates the Commission's request for comment on this important issue. We believe that the care that Congress took to specifically exclude deferred delivery contracts which are intended to be physically settled from the general definition of "swap" is based on the importance of such contracts in the commerce of the Nation. We further believe that the contracts described in this comment, including ONEOK's premium services contracts, fall within that exclusion. As discussed above, these contracts are distinguishable from options under the factors that the Commission previously has considered. Accordingly, we ask that the Commission clarify its interpretation and address those contracts which are commonly offered in the energy sector in which the parties intend physical settlement and which are for the purpose of delivering the actual energy commodity as, and to the extent, needed by the contracting parties.

We would be happy to discuss our comments at greater length with the staff. If you have any questions regarding ONEOK's comments, please feel free to contact Vicky Hale, Vice President and Associate General Counsel, Compliance and Regulatory, ONEOK, Inc. at 918-588-7949, Michael L. Pate, Managing Attorney, ONEOK Partners at 918-588-7022, or Paul M. Architzel of Wilmer Cutler Pickering Hale and Dorr LLP, outside counsel to ONEOK, at (202) 663-6240.

Respectfully submitted,

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