

June 7, 2012

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

Re: Treatment of Physically-Settling Commodity Option Transactions, RIN Nos.
3038-AD62, 3038-AD46

Dear Mr. Stawick:

On April 27, 2012, the Commodity Futures Trading Commission's ("CFTC" or "the Commission") Final Rule and Interim Final Rule on Commodity Options ("the Commodity Options Rule") was published in the Federal Register.¹ In the Commodity Options Rule, the Commission, *inter alia*, implements "the commodity option rules as proposed in the [Notice of Proposed Rulemaking], whereby commodity options are permitted subject to the same rules as all other swaps[.]" together with "a new trade option exemption."²

In the Commodity Options Rule, the Commission also made clear that "[f]or the purposes of this release, the Commission uses the term 'commodity options' to apply solely to commodity options not excluded from the swap definition set forth in [Commodity Exchange Act ("CEA")] section 1a(47) (A)[.]"³ which is the subject of an on-going rulemaking to further define the term "Swap."⁴ The Commission stated in the Commodity Options Rule that it would accept comments on the trade option exemption which it has adopted as an interim final rule until June 26, 2012.⁵

By this letter, the Coalition of Physical Energy Companies ("COPE")⁶ provides comment on the Commodity Options Rule and the Swap Definition Rulemaking and, in particular, seeks that the

¹ 77 Fed. Reg. 25320 (April 27, 2012).

² *Id.* at 25325.

³ Commodity Options Rule, 77 Fed. Reg. 25320 at 25321 fn 6.

⁴ See *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 76 FR 29818, (Notice of Proposed Rulemaking) (May 23, 2011) (the "Swap Definition Rulemaking").

⁵ COPE intends to separately offer comments on the interim final rule, as invited by the Commission.

⁶ The members of the Coalition of Physical Energy Companies are: Apache Corporation; El Paso Corporation; Enterprise Products Partners, L.P.; Iberdrola Renewables, Inc.; Kinder Morgan; MarkWest Energy Partners, L.P.; Noble Energy, Inc.; NRG Energy, Inc.; Shell Energy North America (US), L.P.; SouthStar Energy Services LLC; and Targa Resources.

Commission exclude commodity options that are intended to and can only settle physically from the definition of Swap and, therefore, the scope of the Commodity Options Rule.

COPE members are physical energy companies in the business of producing, processing, and merchandizing energy commodities at retail and wholesale. COPE members utilize swaps to hedge the commercial risk of their physical businesses. COPE members also engage in transactions involving commodity options.

The Commission Should Not Define Physically Settling Commodity Options As Swaps

As set forth in CEA section 1a(47)(B)(ii), a sale of a nonfinancial commodity for deferred shipment or delivery **is not a Swap** “so long as the transaction is intended to be physically settled[.]”⁷ COPE believes that under the statute commodity options that are both intended to be physically settled and cannot, by their terms, be settled financially, cannot be considered Swaps.

COPE offers the following example, to illustrate the type of commodity option transaction to which it is referring. The Option Buyer enters into a transaction with the Option Seller to provide it the right to deliver or receive a *physical product*. The only financial element to the transaction is the payment of a premium to the Option Seller by the Option Buyer (typically required within two business days of execution). By payment of the premium, the Option Buyer obtains the right to deliver or receive the *physical product*. If the Option Buyer properly exercises its option to purchase the physical product at the predetermined strike or exercise price, then physical delivery of the product to the Option Buyer will occur. If the Option Buyer does not properly exercise its option, the option expires and no physical delivery occurs. There is no provision for financial settlement; performance of the transaction is entirely physical.

These transactions are typically entered into to provide a participant in physical energy markets the ability to ensure the supply or sale of a physical product at a specified price. For example, a buyer of natural gas planning for its supply needs for the winter heating season may secure “peaking supplies” to make sure it has physical product at a known price if colder than expected weather occurs. Further, a power generator may want to obtain the right to sell its physical product at a known price if spot market prices fall below a certain threshold. In these cases, there is either physical delivery or option expiration without exercise. The Option Buyer is securing the right to buy or sell a physical product and nothing more.

These examples are not theoretical or academic. In fact, they are grounded in energy industry standard physical transaction documents and practices. For example, the following definitions pertaining to option transactions are found in the Edison Electric Institute Master Power Purchase & Sale Agreement (“EEI Agreement”),⁸ which is an exclusively *physical* power trading agreement:

“Option” means the right but not the obligation to purchase or sell a Product as specified in a Transaction.

⁷ 7 U.S.C. § 1a(47)(B)(ii) (2012).

⁸ EEI Master Power Purchase & Sale Agreement, Version 2.1 (modified April 25, 2000); <http://www.eei.org/Pages/default.aspx>.

“Product” means electric capacity, energy or other product(s) related thereto as specified in a Transaction by reference to a [Physical Power] Product listed in Schedule P hereto or as otherwise specified by the Parties in the Transaction;

Option Buyer” means the Party specified in a Transaction as the purchaser of an option, as defined in Schedule P.

“Option Seller” means the Party specified in a Transaction as the seller of an option, as defined in Schedule P.

“Call Option” means an Option entitling, but not obligating, the Option Buyer to purchase and receive the Product from the Option Seller at a price equal to the Strike Price for the Delivery Period for which the Option may be exercised, all as specified in the Transaction. Upon proper exercise of the Option by the Option Buyer, the Option Seller will be obligated to sell and deliver the Product for the Delivery Period for which the Option has been exercised.

“Put Option” means an Option entitling, but not obligating, the Option Buyer to sell and deliver the Product to the Option Seller at a price equal to the Strike Price for the Delivery Period for which the option may be exercised, all as specified in a Transaction. Upon proper exercise of the Option by the Option Buyer, the Option Seller will be obligated to purchase and receive the Product.

“Transaction” means a particular transaction agreed to by the Parties relating to the sale and purchase of a Product pursuant to this Master Agreement.

Options are “Transactions” under the EEI Agreement and are confirmed using a form similar to the Confirmation Letter format included as Exhibit A of the EEI Agreement (attached hereto).

Under the forgoing construct, the Option Buyer pays an option premium to the Option Seller and obtains the right to deliver or receive physical power. There is no financial settlement available. This is, without question, a physical product transaction which contemplates and requires physical settlement. Further this structure is not unique to physical power transactions. While the standard natural gas physical trading agreement, the NAESB Base Contract for the Sale and Purchase of Natural Gas (“NAESB Agreement”),⁹ does not include such language, it is very often added as “Special Conditions” by the parties to a NAESB Agreement.

In view of the foregoing, COPE seeks that the Commission recognize the physical nature of commodity options such as those transacted pursuant to the EEI Agreement and the supplemented NAESB Agreement in its ongoing efforts to further define the term “Swap.” These transactions are exactly the type of sales Congress intended to exclude from the definition of “Swap” by providing that a transaction is not a swap “so long as the transaction is intended to be physically settled.”¹⁰

⁹ See Base Contract for Sale and Purchase of Natural Gas, North American Energy Standards Board, Inc. (Version April 19, 2002).

¹⁰ See *supra* fn 7.

Beyond the statutory basis for a finding that commodity options such as those described herein are not Swaps, COPE can discern no regulatory benefit for their inclusion within the final definition of that term. These physical trades cannot be utilized by speculators, as they require physical delivery of the physical product and cannot settle financially. For similar reasons, they cannot be exchange-traded or cleared. In sum, they are outside of the swap/derivatives world.

Finding physical commodity options to be Swaps will lead to inadvertent issues not addressed by the Commission. As COPE understands it, if such transactions are considered Swaps (regardless of the fact that they are trade options) they will be subject to CFTC regulations concerning matters such as Swap Documentation,¹¹ External Business Conduct Standards,¹² and other seemingly inapplicable regulatory elements for physical transactions. Further, since an option may cover a considerable period (a winter heating season of 5 months) and also be subject to a shorter exercise period (day, week month, on peak, off peak or around-the-clock), these transactions will become some sort of hybrid with the exercised deliveries not considered a Swap and the unexercised remaining portion of the term considered a Swap. This will cause needless regulatory confusion with regulated and unregulated elements of the same transaction and regulatory ambiguity between the Commission and other regulators.

COPE acknowledges that in the Commodity Options Rule, the Commission has made the applicability of the trade option exemption contingent upon intended physical settlement.¹³ That provision is still subject to comment as part of the interim final rule. The Commission has also found that only options found to be Swaps under the final rules resulting from the Swap Definition Rulemaking will be subject to the Commodity Options Rule.¹⁴ COPE urges the Commission to not let the Commodity Options Rule prejudice the final outcome of the Swap Definition Rulemaking in the context of commodity options. The type of options described above should not be found to be Swaps. Only commodity options that have features that permit financial settlement should be considered Swaps.

¹¹ *Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 6715 (Notice of Proposed Rulemaking) (Feb. 8, 2011).

¹² See 17 C.F.R. §§ 23.400-23.451 (2012).

¹³ See 17 C.F.R. § 32.3(a)(3) (2012).

¹⁴ See *supra* fn 3.

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Conclusion

Therefore, based on the foregoing, COPE strongly encourages the Commission to make clear that commodity option transactions that are intended to, and can only, settle physically are not Swaps, consistent with the statutory language of Dodd-Frank.

Very truly yours,

/s/ David. M. Perlman

David M. Perlman
Bracewell & Giuliani LLP

**Counsel to
Coalition of Physical Energy Companies**

CC:

The Honorable Gary Gensler, Chairman
The Honorable Jill E. Sommers, Commissioner
The Honorable Bart Chilton, Commissioner
The Honorable Scott D. O'Malia, Commissioner
The Honorable Mark Wetjen, Commissioner
Mr. Dan Berkovitz, General Counsel
COPE Members

**MASTER POWER PURCHASE AND SALE AGREEMENT
CONFIRMATION LETTER**

This confirmation letter shall confirm the Transaction agreed to on _____, ____
between _____ (“Party A”) and _____ (“Party B”)
regarding the sale/purchase of the Product under the terms and conditions as follows:

Seller: _____

Buyer: _____

Product:

Into _____, Seller’s Daily Choice

Firm (LD)

Firm (No Force Majeure)

System Firm

(Specify System: _____)

Unit Firm

(Specify Unit(s): _____)

Other _____

Transmission Contingency (If not marked, no transmission contingency)

FT-Contract Path Contingency Seller Buyer

FT-Delivery Point Contingency Seller Buyer

Transmission Contingent Seller Buyer

Other transmission contingency

(Specify: _____)

Contract Quantity: _____

Delivery Point: _____

Contract Price:

Energy Price: _____

Other Charges: _____

Delivery Period: _____

Special Conditions: _____

Scheduling: _____

Option Buyer: _____

Option Seller: _____

Type of Option: _____

Strike Price: _____

Premium: _____

Exercise Period: _____

This confirmation letter is being provided pursuant to and in accordance with the Master Power Purchase and Sale Agreement dated _____ (the "Master Agreement") between Party A and Party B, and constitutes part of and is subject to the terms and provisions of such Master Agreement. Terms used but not defined herein shall have the meanings ascribed to them in the Master Agreement.

[Party A]

[Party B]

Name: _____

Name: _____

Title: _____

Title: _____

Phone No: _____

Phone No: _____

Fax: _____

Fax: _____