Janet Langford Kelly
Senior Vice President, Legal
General Counsel and Corporate Secretary

ConocoPhillips Company
600 North Dairy Ashford – PE 3034
Houston, TX 77079-1175
Phone: 281.293.3122
Fax: 281.293.1054
Janet.L.Kelly@conocophillips.com

August 23, 2012

Via E-mail

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

Re: Public Comments on the Commission's Interpretation Regarding Forwards with Embedded Volumetric Options

Dear Mr. Stawick:

I. Introduction.

ConocoPhillips hereby submits these comments in response to the interpretation of the Commodity Futures Trading Commission (the "Commission") regarding forwards with embedded volumetric optionality (the "Interpretation") promulgated as part of the final rules setting forth the definition of the term "swap" (the "Final Rules").[1] In addition, ConocoPhillips hereby submits comments relating to the treatment of reservation agreements in the Final Rules. ConocoPhillips appreciates the opportunity to provide these comments and respectfully requests the Commission's consideration of such comments.

ConocoPhillips is the largest North American-based independent exploration and production company. Headquartered in Houston, Texas, ConocoPhillips has operations and activities in 30 countries and approximately 16,500 employees as of June 30, 2012. Production averaged 1.59 million BOE per day for the six months ended June 30, 2012, and proved reserves were 8.4 billion BOE as of December 31, 2011. More information may be found at www.conocophillips.com. ConocoPhillips has regularly participated in the public discussion of the rules and regulations created to implement the Dodd Frank Act, most commonly as a part of an industry association or working group.

1 *See* CFTC and SEC, *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Recordkeeping*, 77 Fed. Reg. 48208 (August 13, 2012).

II. Comments of ConocoPhillips.

A. The Seven-part Test.

As part of the Interpretation, the Commission has proposed a seven-part test[2] to determine whether a forward contract with embedded volumetric optionality will be considered a commodity option. We believe that this test will have unintended negative consequences for the physical marketplace, in particular, commercial end-users.

1. Part Seven.

The seventh part of the test ("Part 7") imposes a requirement that the exercise (or non-exercise) of embedded volumetric optionality "... is based primarily on physical factors ... that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity."[3] This part of the test is problematic for two reasons: (1) the articulated standard is unworkably vague and the intent of the requirement conflicts with the customary industry practice that a business exercise ordinary prudence in its decisions; and (2) Part 7 imposes requirements beyond the scope of the statute.

Part 7 appears to impose a standard that the exercise or non-exercise of the embedded optionality happens automatically, almost without any decision on the part of the holder of the optionality. The phrase used to describe this standard in the Final Rules themselves is "based primarily", although footnote 341,[4] which appears to be intended to

---

[2] *See* 77 Fed. Reg. 48238 (the Commission has set forth a seven-part test for determining whether a contract with volumetric optionality is a forward contract or a commodity option).

[3] 77 Fed. Reg. at 48238.

[4] "In other words, the predominant basis for failing to exercise the option would be that the demand or supply (as applicable) that the optionality was intended to satisfy, if needed, never materialized, materialized at a level below that for which the parties contracted or changed due to physical factors or regulatory requirements outside the parties' control. Such failure to exercise, or an exercise for a reduced amount of the underlying commodity, could, for example, be due to colder than expected weather during the summer decreasing demand for air conditioning, in turn decreasing demand for power to run the air conditioning. The Commission does not interpret this to mean that absolutely all factors involved in the decision to exercise an option must be beyond the parties' control, but rather the decision must be predominantly driven by factors affecting supply and demand that are beyond a party's control. This also means that the forward contract with embedded volumetric optionality needs to be a commercially appropriate method for securing the purchase or sale of the nonfinancial commodity for deferred shipment at the time it is entered into. The CFTC cautions market participants that, to the extent a party relies on the forward exclusion from the swap or future delivery definitions, notwithstanding that there is volumetric optionality, if that volumetric optionality is inconsistent with the seventh element of the

clarify the test, substitutes the phrase "predominant basis". The use of "predominant" as if it were synonymous with "primary" both illustrates and contributes to the confusion of an entity that is attempting to determine the status of a transaction. In any event, the clear sense of these terms is that the Commission intends that exercise is a mere consequence of events external to the option holder, not a result of intentional decision-making. In some situations, such as the full-requirements contracts discussed later in the Final Rules, this may be an appropriate characterization. In the general case, however, this type of embedded volumetric optionality is created for the purpose of providing the option holder with flexibility to respond to changing circumstances. Circumstances external to the holder may create the need to acquire additional supply or to reduce supply purchases of a nonfinancial commodity, but the option holder will ordinarily exercise business judgment to select the best alternative to acquire that supply.

Consider the example of a weather-sensitive natural gas consumer that has a base load supply contract for 100,000 dekatherms of natural gas per day for the winter priced at first-of-month index ("FOM"), and this supply contract also provides the consumer, on any day, the option to take an additional 20,000 dekatherms (also priced at FOM) or to put back to the supplier 20,000 dekatherms (priced at FOM). Assume further that the consumer has natural gas storage from which supply can be taken. In the event of a spike of cold weather, this consumer's demand will increase. (This weather event provides an example of a factor "outside the control of the parties" and "influencing the demand for … the nonfinancial commodity.") To satisfy this increase in demand, the consumer has three choices:

i. it can exercise the volumetric optionality;
ii. it can acquire natural gas in the daily market, at a Gas Daily price; or
iii. it can withdraw natural gas from storage.

Good corporate governance requires that the consumer's decision among these alternatives should be based on the most attractive alternative from a business perspective. Exercise of the volumetric optionality might be the best alternative, and the commercial entity has a corporate obligation to make the decision that is best for the company. In this example, exercise of the volumetric optionality therefore is a result of: (1) an exogenous event that creates additional demand; and (2) a business decision by the option holder that exercise is the most appropriate means to satisfy this additional demand. Both of these prongs are necessary for the commercial entity to decide to exercise the volumetric optionality, and it is therefore difficult to argue that exercise is primarily or predominantly based on factors outside the control of the counterparties,

---

interpretation, the agreement, contract or transaction may be an option." 77 Fed. Reg. at 48238, n.341.

given the ordinary meaning of "primarily" or "predominantly". In this example, it appears that good corporate governance may require the consumer to fail Part 7.

Therefore, we believe that Part 7 should not be included in this test or in the Interpretation. The critical element of the statutory exclusion of forward contracts is the intent to settle the contract physically. The first five prongs of this test establish the necessary elements to show the intent to make and take physical delivery, but Part 7 of the test goes beyond this requirement to look to the motivation behind exercise or non-exercise. That is an improper enlargement of the statutory requirement, and should be removed from the test. We do not believe that Congress intended the motivation of a counterparty in exercising to be relevant in determining whether a transaction is a swap, option or forward so long as physical delivery of the underlying commodity is intended.

In addition to the aforementioned concerns, we note that a commercial counterparty to a transaction cannot know the true intentions of its counterparty at the outset of the agreement. A counterparty can receive a representation and warranty of its counterparty's anticipated potential intention in exercising the volumetric optionality in the contract. However, in order for the contract not to be considered a commodity option, the counterparties must have a good faith belief at the outset that the volumetric optionality in the contract will be exercised predominantly because the demand for the commodity did not arise or arose at a level below that for which the parties contracted or changed due to physical factors outside of the control of the parties. Because each counterparty will be subject to a duty of good corporate governance, each counterparty must assume that the option holder may exercise the volumetric optionality as the result of an optimal business decision. Therefore, it would be impossible to establish this good faith belief even by representation and warranty.

Moreover, when a portion of the test cannot be evaluated until the volumetric optionality is exercised – well after the transaction has been entered into (*i.e.*, the time at which the counterparties must determine whether a transaction is a commodity option subject to Title VII regulation) – the requisite regulatory certainty is not obtainable. In the case of embedded volumetric optionality, the parties can (and do) know at the time of the transaction that each party is legally bound to fulfill all its obligations under the contract, and, therefore, both parties know that each party intends to complete physical delivery for the option volumes if the optionality is exercised (and, for volumes unaffected by the optionality, to complete physical delivery regardless of exercise). As discussed above, a counterparty cannot know at the outset of the transaction which factors will motivate a counterparty's exercise or non-exercise of volumetric optionality in the future. Requiring such fore-knowledge necessarily creates inappropriate regulatory uncertainty, especially when accounting for the necessity to determine whether a transaction is an option at the outset.

We respectfully request that the Commission remove Part 7 from the test in the Final Rules. We believe that the test without Part 7 will still accomplish Congress' intention of ensuring that contracts that satisfy the requirements of the test will be contracts in which the commercial counterparties intend to make and take delivery at the outset. In addition, removing Part 7 will avoid subjecting widely used physical commercial contracts to regulation as over-the-counter derivatives, something we believe neither Congress nor the Commission intended or intends to do.

2. **Parts Four and Five.**

The fourth and fifth parts of the test relate to a counterparty's commitment to make or take delivery (if the option is exercised) of the underlying commodity. These tests are appropriate, but there appears to be an oversight in the drafting. The description of the obligations to make or take delivery, as described in the fourth and fifth parts, are correct for call options, but not for put options. Elsewhere, the Final Rules appear to contemplate reductions as well as increases in delivered quantity, and we therefore believe it is the Commission's intent to apply a single consistent standard to both put options and call options.

As written, the fourth part of the test states "[t]he seller … intends … to deliver … if the optionality is exercised", with the fifth part providing the parallel requirement that "[t]he buyer … intends … to take delivery …."[5] That pattern of making and taking delivery is correct if the option is a call, but the roles of making and taking delivery are reversed if the option is a put. For a put option, it is the holder of the put that makes delivery, and the seller of the put that takes delivery. The drafting can be clarified by replacing the phrase "to deliver" in the fourth part with the phrase "to deliver or take delivery, as appropriate", and to replace the phrase "to take delivery" in part five with the phrase "to take delivery or deliver, as appropriate".

Thus, in the example used above, the natural gas consumer might discover that it did not need the full 100,000 dekatherms on a particular day and decide to put the excess back to the supplier (up to the 20,000 dekatherms limit on the put). In this case, the consumer would deliver under the put, and the supplier would take delivery. (In practice, of course, the more likely outcome is that the put volume and an offsetting amount of the base load contract would be "booked out" so that the supplier and consumer would schedule only the net amount for delivery. The standard terms of these embedded options require notice of exercise from the option holder in time to coordinate the net quantity to be delivered.)

---

[5] 77 Fed. Reg. at 48238.

A similar issue exists in the discussion of the fourth and fifth parts, where the Final Rules state that "[t]his distinguishes a forward contract from a commodity option, where only the option seller must at all times be prepared to deliver during the term of the option."[6] In fact, both counterparties to an option must at all times stand ready to perform their obligations. The difference with an option is that the holder has sole control of whether those obligations will be triggered. If the option is triggered, both parties are obligated to perform, and either party could be making or taking delivery depending on whether the option is a put or a call.

We respectfully request the Commission confirm that these parts of the test are not intended to exclude options that are puts by amending the text of the test in the Final Rules in the manner described above.

B. <u>Usage Contracts.</u>

In addition to concerns about the seven-part test for embedded options, we would like to highlight our concerns with the portion of the Final Rules that deals with "*Certain Physical Commercial Agreements, Contracts or Transactions*"[7]. This section of the Final Rules endeavors to address the regulatory treatment of agreements that provide for the usage of facilities such as pipelines, storage facilities or power stations. We believe that the statement in this section (set forth below) overly expands the scope of the definition of commodity option and should be clarified or removed. In particular, the final paragraph of the section creates an inappropriate extension of swaps regulation to commercial agreements that have never been used as, or considered to be, swaps. That paragraph states:

> However, in the alternative, if the right to use the specified facility is only obtained via the payment of a demand charge or reservation fee, and the exercise of the right (or use of the specified facility or part thereof) entails the further payment of actual storage fees, usage fees, rents, or other analogous service charges not included in the demand charge or reservation fee, such agreement, contract or transaction is a commodity option subject to the swap definition.[8]

---

6 77 Fed. Reg. at 48239.

7 77 Fed. Reg. at 48242.

8 77 Fed. Reg. at 48242.

This paragraph suggests that every facility usage contract that entails both a demand charge (or reservation fee) and a variable cost is an option subject to regulation under Dodd Frank. However, this two-tiered fee structure is, in fact, the standard fee structure for a wide variety of usage contracts, including interstate transportation of natural gas, which is regulated by the Federal Energy Regulatory Commission ("FERC"). For example, in its Order 636, FERC adopted what it calls the "straight fixed variable method" as the default approach for rate design,[9] where this "straight fixed variable method" is characterized by precisely the combination of a fixed demand charge and a variable usage fee that is the subject of the referenced paragraph in the rule.

Examples of other agreements that are often structured with this two-tier approach include:

- tolling agreements for electricity generation;[10]
- storage;[11]
- re-gasification of imported LNG;[12]
- marine vessel chartering;[13] and
- terminal arrangements.[14]

---

9 *See* FERC, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, 57 Fed. Reg. 13267, at 13279 (April 16, 1992) ("In addition, this rule adopts the straight fixed variable method for rate design, unless the Commission provides otherwise.").

10 A tolling agreement is an agreement whereby the owner of an electric generation facility agrees to convert fuel provided by its counterparty into electricity and deliver the electricity back to the counterparty. Often times pursuant to these agreements, the counterparty will pay a reservation fee to the facility owner and a price per use of the facility.

11 Pursuant to a storage agreement, a commercial counterparty will pay a reservation fee for the right to use a storage facility. In many storage agreements, the counterparty will then pay the owner of the storage facility a price per usage of the storage facility.

12 Pursuant to re-gasification agreements, a commercial counterparty will agree with the owner of a re-gasification facility to pay a reservation fee for the right to use the facility at a certain time. The counterparty will frequently then pay a price for actual usage of the re-gasification facility.

13 Pursuant to a marine vessel chartering agreement, a commercial entity would pay a ship owner a reservation fee to use the vessel at a certain time. Often times pursuant to these agreements, the commercial entity may then pay an additional for the actual usage of the vessel.

14 Pursuant to a terminal agreement, a commercial entity would pay for the right to use the terminal. Often times pursuant to these agreements, the commercial entity would then pay for the actual usage of the terminal.

This portion of the rule also creates the potential for substantial unintended negative consequences that are not addressed in the Final Rules. These usage contracts are commonplace in the energy industry and an important part of the process by which new infrastructure is created and existing infrastructure is maintained. Regulating these contracts as if they were swaps will have a chilling effect on investment in infrastructure, and that, in turn, will tend to decrease investment in productive capacity. For example, in the energy industry, new energy supplies are almost always found at some distance from the natural consumers of that energy. Therefore, some means must be found to transport the new production to a demand center. Contracts such as these usage contracts often play a critical role in developing that transportation, and without the transportation, the production is not likely to be developed. This dependency arises in part because of economic specialization: facilities companies develop, own, and operate facilities (such as pipelines, ships, marine terminals); resource companies develop and consume production, and are natural users of the facilities. These contracts allow companies to separate using a facility from owning and operating a facility, thus allowing companies to focus their resources on what they do best.

We do not believe that Congress intended to subject these commercial contracts that are common throughout the industry to the regulatory structure that was created for over-the-counter derivative transactions,[15] nor do we believe that the letter of the statute allows for such an outcome. In addition, if the Commission did intend to impose such regulation on these contracts used by commercial end-users, the Commission has an obligation to provide the public with notice and opportunity for comment, neither of which was provided in the first instance.

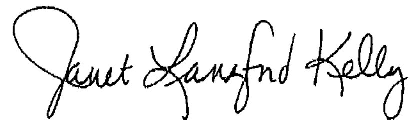
---

15 If these contracts are considered commodity options and treated as swaps, many commercial end-users may be deemed swap dealers or major swap participants. This clearly contradicts the intent of the statute. *See, e.g.,* Letter from Senators Christopher Dodd and Blanche Lincoln to Congressmen Barney Frank and Colin Peterson, dated June 30, 2010 ("the Major Swap Participant and Swap Dealer definitions are not intended to include an electric or gas utility that purchases commodities that are used either as a source of fuel to produce electricity or to supply gas to retail customers…").

III. Conclusion.

ConocoPhillips supports appropriate regulation as a necessary element of well-functioning over-the-counter derivative markets, and we appreciate the effort the Commission is making to bring greater transparency and stability to global financial markets. We appreciate the opportunity to provide comments on these issues.

Respectfully submitted,



Name: Janet Langford Kelly
Title: Senior Vice President, Legal
General Counsel and Corporate Secretary

cc: The Hon. Gary Gensler, Chairman
The Hon. Jill E. Sommers, Commissioner
The Hon. Bart Chilton, Commissioner
The Hon. Scott D. O'Malia, Commissioner
The Hon. Mark P. Wetjen, Commissioner
(Commodity Futures Trading Commission)