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Submitted Electronically

Ms. Stacy Yochum
Acting Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Interpretation Regarding Forwards with Embedded Volumetric Optionality, RIN 3038-AD46

Dear Ms. Yochum:

The American Petroleum Institute ("API") submits these comments in response to the interpretation issued by the Commodity Futures Trading Commission (the "Commission" or "CFTC") regarding (1) forwards with embedded volumetric optionality (the "Volumetric Optionality Interpretation"),[1] and (2) certain physical commercial agreements for the supply and consumption of energy that provide flexibility, such as tolls on power plants, transportation agreements on natural gas pipelines, and natural gas storage agreements (the "Usage Contracts Interpretation").[2]

API is a national trade association representing more than 500 oil and natural gas companies. API's members transact in physical and financial, exchange-traded, and over-the-counter markets primarily to hedge or mitigate commercial risks associated with their core business of delivering energy to wholesale and retail consumers. Associated with the hedging of physical exposures, API members enter into swap transactions to offset credit risks and to facilitate physical transactions. API members range from the largest major oil company to the smallest of independents. They are producers, refiners, suppliers, pipeline operators, and marine transporters, as well as service and supply companies that support all segments of the industry.

[1] The Volumetric Optionality Interpretation is set forth in Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping (the "Product Definitions Release"), 77 Fed. Reg. 48,208, 48,237-42 (Aug. 13, 2012).

[2] The Usage Contracts Interpretation is set forth in the Product Definitions Release, 77 Fed. Reg. at 48,242-43.

Because API members rely on the integrity of markets under the Commission's jurisdiction, we appreciate the opportunity to comment.

I. Introduction

As we have previously explained, members of the oil and gas industry commonly use commercial contracts with flexible delivery terms to balance changing and sometimes unpredictable customer or supplier demands. For the reasons we have previously stated and those set forth here, we do not believe these contracts should be considered options and regulated as swaps. Accordingly, we agree with the Commission that "agreements, contracts, and transactions with embedded volumetric optionality may satisfy the forward exclusions from the swap and future delivery definitions under certain circumstances."[3] We are writing, however, to request further clarity with respect to the scope and operation of these interpretations and to express our concern that, as drafted, these interpretations could subject common commercial contracts critical to the reliable operation of the energy industry to unwarranted new regulatory burdens.

- *Volumetric Optionality Interpretation.* The Commission's test for determining whether a contract with embedded volumetric optionality is a forward, on the one hand, or a swap, on the other, must be sufficiently clear that market participants can apply it in the context of their businesses and know with certainty whether transactions will be subject to swap regulation. In this regard, we respectfully request that the Commission:
    - Delete the seventh element of the Volumetric Optionality Interpretation.
    - Clarify that the fourth and fifth elements of the Volumetric Optionality Interpretation apply equally to embedded optionality related to reductions, as well as increases, in delivery (i.e., put options and call options).
- *Usage Contracts Interpretation.* We respectfully request that the Commission clarify that usage contracts having a two-tiered pricing structure will not be regulated as swaps.

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[3] *Id.* at 48,238.

II. Volumetric Optionality Interpretation

A. The Forward Exclusion Should Apply When Parties Make a Business Decision to Exercise Volumetric Optionality

The Commission set forth a seven-part test for determining whether an agreement, contract, or transaction falls within the forward exclusion from the swap and future delivery definitions, notwithstanding that it contains embedded volumetric optionality. Although we understand the Commission's interest in financial options, we are concerned that the Commission's seven-factor test relating to physical options is unduly restrictive, and will, in practice, prove unworkable to market participants. We are particularly concerned that the seventh element of the test will inappropriately capture typical commercial contracts that are used to transfer commodities. That element states that the forward exclusion applies only when "[t]he exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity."[4] In a footnote, the Commission explained that, under this part of the test, "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."[5] Acknowledging the doubt that would confront market participants forced to determine whether their exercise or non-exercise of volumetric optionality was based "primarily" or "predominantly" on supply or demand, the Commission "caution[ed] 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 Interpretation, the agreement, contract or transaction may be an option."[6]

First, the Volumetric Optionality Interpretation improperly focuses on the motivation of the parties at the time the embedded volumetric optionality is exercised or not exercised, rather than on the facts and circumstances at the time the contract is entered into. Thus, market participants will not be able to determine at the outset of the transaction whether it is subject to regulation under Title VII of the Dodd-Frank Act or whether, because it is a forward contract, it is not subject to such regulation. By requiring parties to predict the reasons they will exercise, or not exercise, volumetric optionality at some point in the future, the Volumetric Optionality Interpretation introduces unwarranted regulatory uncertainty. In this regard, we note

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[4] *Id.* (footnotes omitted).

[5] *Id.* n.341.

[6] *Id.*

that the fourth and fifth elements of the Volumetric Optionality Interpretation focus properly on intent "at the time [the party] enters into the agreement, contract, or transaction."[7] In addition, the seventh element is inconsistent with the principle, recognized elsewhere in the Product Definitions Release, that the determination whether an agreement, contract, or transaction is a swap must be made prior to execution because, among other things, certain duties, such as business conduct standards, apply to swaps prior to execution.[8]

Second, the Commission's focus on the primary or predominant basis for the decision to exercise, or not exercise, volumetric optionality is vague and unworkable. Take, for example, a natural gas provider whose customer demand for gas increases when the weather gets colder. The change in weather is a "physical factor . . . outside the control of the parties [that] influenc[es] demand for . . . the nonfinancial commodity."[9] If the gas provider has entered contracts with suppliers providing for volumetric optionality to enable it to meet increased customer demand in the event of a cold day, it could decide to exercise that optionality to acquire more natural gas under the contract. But it could also buy gas in the market or withdraw gas from storage. Although the increased demand for gas is triggered by physical factors outside the parties' control, the decision to exercise optionality is ultimately a business decision made after evaluating the costs and benefits of the various options available for meeting the customer's gas requirements. It is unclear how the Commission's test would evaluate this decision, which in one respect, is primarily based on changes in demand that trigger the decisionmaking process, but in another respect, follows from an assessment of the relative costs and benefits of the options for responding to those changes in demand.

Due to the difficulty in creating a seventh factor that would adequately describe the complex motivations for exercising volumetric optionality, and due to the need for a test that can be applied at the inception of the agreement, we urge the Commission to delete the seventh element of the Volumetric Optionality Interpretation.

B. The Forward Exclusion Should Apply to Both Embedded Put and Call Options

As drafted, the fourth and fifth elements of the Volumetric Optionality Interpretation could be read to apply only to call options, in which "[t]he seller of a nonfinancial commodity . . . intends to deliver," and "[t]he buyer of a nonfinancial commodity . . . intends . . .

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[7] *Id.* at 48,238.

[8] *See id.* at 48,262 & n.625 ("With respect to swaps, the determination [of whether a Title VII instrument is either a swap or a security-based swap] also would need to be made no later than the time that provisions of the CEA and the regulations thereunder become applicable to a Title VII Instrument. For instance, certain duties apply to swaps prior to execution.").

[9] *See id.* at 48,238; *see also id.* n.339 (recognizing "weather" among such physical factors).

to take delivery."[10] The roles would be reversed in the case of put options, where the seller would take delivery and the buyer would make delivery. We see no reason why the Volumetric Optionality Interpretation should not apply equally to embedded put options, and the Commission has not identified any such reason. Accordingly, API requests that the Commission clarify that the fourth and fifth elements apply equally to put options, as well as call options.

III. Usage Contracts Having a Two-Tiered Pricing Structure Should Not Be Regulated as Swaps

API supports the Commission's conclusion that certain physical commercial agreements for the supply and consumption of energy that provide flexibility, such as tolls on power plants, transportation agreements on natural gas pipelines, and natural gas storage agreements may qualify for the forward contract exclusion.[11] We disagree, however, with the Commission's suggestion that "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."[12]

Many commercial contracts typical in the energy industry have a two-tiered fee structure entailing a demand charge (or reservation fee) and a variable cost. These are, in effect, two components of the overall price of the product. As noted by other commenters, common contracts employing a two-tiered structure include tolling agreements for electricity generation, storage, regasification of imported liquefied natural gas, marine vessel chartering, and terminal agreements. Indeed, the two-tiered fee structure of some such contracts may be mandated by the Federal Energy Regulatory Commission ("FERC"). For example, in its Order 636, FERC adopted the "straight fixed variable" method as the default approach for rate design. Under the "straight fixed variable" approach, pipelines are required to allocate fixed costs to the reservation charge, and variable costs to the usage charge.[13]

In the energy industry, new energy supplies are almost always found some distance away from energy consumers. Usage contracts therefore play a critical role in developing transportation from energy supply to energy demand. The two-tiered pricing allows companies to separate out the cost of using the transportation facility from owning and operating

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[10] *Id.* at 48,238.

[11] *See id.* at 48,242-43.

[12] *Id.* at 48,243.

[13] *See, e.g., Texaco Inc. v. FERC*, 148 F.3d 1091, 1094 (D.C. Cir. 1998).

that facility. We do not believe that Congress intended to subject these common commercial contracts to comprehensive swaps regulation.

Treating usage contracts as swaps will impose substantial new regulatory burdens that will chill investment in infrastructure and, as a result, chill investment in productive capacity. We are concerned, for example, that treating usage contracts as swaps could mean that energy companies would not be able to take advantage of the bona fide hedge exemption to position limits, or the end-user exception to mandatory clearing, for these contracts.

Accordingly, we respectfully request that the Commission reconsider the rationale and ensuing regulatory burdens of its proposed approach to treat usage contracts as options and thereby as swaps. We do not believe Congress intended this result, which would adversely affect the energy industry and would ultimately raise the cost of energy for American consumers.

IV. Conclusion

For the reasons described in these comments, API requests that the Commission clarify that the forward exclusion applies to agreements, contracts, or transactions with embedded volumetric optionality when the decision to exercise volumetric optionality is a business decision regarding how to respond to physical factors or regulatory requirements that are outside the control of the parties and are influencing the demand for, or the supply of, the nonfinancial commodity. To make this clear, API proposes deleting the seventh element of the Volumetric Optionality Interpretation. In addition, API respectfully requests that the Commission clarify that the forward exclusion applies equally to embedded optionality related to reductions, as well as increases, in delivery. In other words, the Commission should clarify that the fourth and fifth elements of the Volumetric Optionality Interpretation apply to both put options and call options. Finally, API respectfully requests that the Commission clarify that usage contracts having a two-tiered pricing structure will not be regulated as swaps.

API appreciates the opportunity to provide these comments. We would be pleased to provide additional information regarding our views on the Volumetric Optionality Interpretation and the Usage Contracts Interpretation, and would welcome the opportunity to work with the Commission. Should you have any questions, please do not hesitate to contact us.

Respectfully Submitted,

Shane Skelton
American Petroleum Institute

cc: Honorable Gary Gensler, Chairman
Honorable Jill E. Sommers, Commissioner

Honorable Bart Chilton, Commissioner
Honorable Scott D. O'Malia, Commissioner
Honorable Mark P. Wetjen, Commissioner