BG GROUP

October 12, 2012

VIA ONLINE SUBMISSION

Ms. Stacy Yochum
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

RE: Interpretation Regarding Forward Contracts with Embedded Volumetric Optionality (RIN 3038-AD46)

Dear Ms. Yochum:

On August 13, 2012, the Commodity Futures Trading Commission ("Commission" or "CFTC") and the Securities and Exchange Commission ("SEC") published in the Federal Register a joint final rule entitled "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping" (the "Final Rule").[1] In the Final Rule, the Commission included a "Request for Comment" concerning its interpretation regarding forward contracts with volumetric optionality.[2] BG Americas & Global LNG ("BGA") respectfully submits these comments in response to the Commission's request.

I. Introduction

BGA is business unit of the BG Group plc ("BG Group"), a global natural gas company based in the United Kingdom and a major producer and supplier of natural gas in the United States. BGA is responsible for all of BG Group's operations in North and South America, the Caribbean, the company's global marine operations and its global liquefied natural gas ("LNG") operations.

BG Group owns natural gas producing assets in Louisiana and Texas known as the Haynesville Shale and in Pennsylvania and West Virginia known as the Marcellus Shale. BG Group is a supplier of LNG to the U.S. and owns import capacity rights at Southern Union Company's Lake Charles, Louisiana ("Lake Charles") and Kinder Morgan's Elba Island, Georgia import terminals. BG Group also has an interest in associated liquids that are extracted from imported LNG at the Lake Charles LNG import terminal. BG Group's subsidiary, BG Energy Merchants, LLC ("BGEM"), is a major marketer of natural gas and electricity throughout certain markets in the United States, and of oil produced by BG Group in offshore Brazil to worldwide markets. BGEM regularly engages in swaps to hedge the commercial risk associated with BG

[1] 77 Fed. Reg. 48208 (August 13, 2012) ("August 13 Order").

[2] *Id.*at 48241

Group's production and marketing activities relating to its natural gas, electricity, liquids, and oil businesses.

II. Comments

A. Seven-Part Test

As part of its interpretation, the Commission has proposed a seven-part test to determine whether contracts with volumetric optionality qualify for the forward contract exclusion. The first six factors relate primarily to whether the contract is intended to be physically settled.[3] The Commission should consolidate these factors into two requirements: (1) the embedded optionality must not be severable; and (2) the parties must be legally bound to physical settlement, including physically settling volumes associated with any volumetric optionality exercised. This change would reduce repetition and ambiguity with regard to the test applied and would remove the subjective factors that currently would require the parties to assume or impute intent to deliver to their counterparties rather than relying on the objectively verifiable existence of a legal obligation to deliver.

The seventh factor of the seven-part test should be deleted or clarified. Under the seventh factor, contracts with embedded volumetric optionality may qualify for the forward contract exclusion only if the "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] The Commission provided two examples of physical factors outside the control of the parties – unscheduled outages and weather changes – but explained that it does not interpret the seventh element "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 parties control."[5]

Contracts with volumetric optionality are commonplace in the energy industry and are entered into by commercial entities to obtain the flexibility needed to efficiently and reliably address the uncertain and changing circumstances that daily affect their operations. In this way, the factors that lead parties to exercise available volumetric optionality are often related to circumstances outside the control of the parties.

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[3] *See Id.* at 48238. Although the third element deals with the severability of the volumetric optionality (*i.e.,* severing the optionality from the forward contract), the other factors all directly relate to the intent to physically settle: (1) the optionality does not undermine the overall nature of the contract as a forward contract (*i.e.,* physical settlement); (2) the predominant feature is actual delivery; (4) the seller intends delivery; (5) the buyer intends delivery; and (6) both parties are commercial parties (*i.e.,* capable of making and taking delivery).

[4] August 13 Order at 48238.

[5] *Id.* at n 340; see also n 345 (noting impact of weather and curtailments on the amount of a commodity delivered).

However, although volumetric optionality can be (and sometimes is) conditioned on specific external events (such as pipeline interruptions or temperature changes), it is a common industry practice to offer volumetric optionality on a less restrictive basis, and rarely is volumetric optionality in the natural gas industry limited to factors outside of both parties' control.

For example, commercial end-users often purchase "swing volumes" that allow them to increase their deliveries to meet their needs. Although these volumes often are called upon as the result of operational conditions beyond the parties' control, they also may be called upon by an end-user based on that end-user's decision to produce more of its products, its decision to switch fuels, or simply because the price agreed to for the swing volumes is better than the current market price. Likewise, a producer may negotiate the right to deliver up to a certain volume of gas primarily because it cannot accurately predict or control production levels, but it ultimately may adjust production levels based on a myriad of factors, or it may find a better market and sell the incremental volumes to a third party. In each case, the contractual rights of the party with regard to its election often are not limited; rather, the party offering the optionality has priced the incremental volumes so that it is willing to make or take delivery of the commodity whenever the party with the right to schedule the incremental volumes so chooses.

To impose a test that is inconsistent with industry practice is likely to push market participants away from the flexible supply arrangements that have led them to rely on and thrive using existing efficient natural gas markets. Moreover, while the cost of treating these purchases and sales as swaps would be substantial, the benefit, if any, would be minimal. The Federal Energy Regulatory Commission ("FERC") already regulates the natural gas and electricity markets, and the additional regulation that would result from treating forward contracts with embedded volumetric optionality as swaps will provide no value to the market - reporting these physical agreements will only muddy the data collected by the Commission, and it is unclear how or why position limits could apply to these types of physical transactions.

Because requiring the exercise of volumetric optionality to be "outside of the control of the parties" is inconsistent with industry practice and would harm market participants, the Commission should delete the seventh factor. If, however, the Commission retains the seventh factor, it should expand upon its statements that the decision to exercise the optionality need not be entirely based on factors outside of the control of the parties. Specifically, the Commission should clarify that the seventh factor is satisfied if the optionality could foreseeably be used to respond to changes in supply and demand or other factors outside of the control of the parties (whether or not that ultimately is the basis upon which one party exercises its right to require delivery). Further, the Commission should make clear that parties need not contractually restrict the right to exercise the volumetric optionality, nor should they be required to determine or rely upon the basis upon which the optionality is exercised. Instead, the seventh factor should be met if, at the time when the contract was executed, it was reasonable to believe that the optionality could be used to address the operational or regulatory requirements of one of the parties.

B. Contingent Forward Agreements

The Commission also should clarify that contracts where the parties intend physical settlement but that are contingent upon events outside of the parties' control are forward contracts and not options. For example, commercial entities may enter into contracts where the obligation to deliver is triggered by an agreed upon trigger price. Such contracts do not involve volumetric optionality; instead, they provide for physical delivery of a predetermined volume based on external factors.

C. Energy Management Agreements

The Commission noted in its August 13 Order that commenters did not adequately support their conclusion that energy management agreements ("EMAs") are forwards (and not swaps) and that commenters did not provide a working definition of EMAs.[6] In the natural gas industry, EMAs generally are arrangements whereby end-users, local distribution companies, producers, or other physical energy market participants outsource their energy procurement or marketing activities and/or the management of their energy infrastructure assets. One example of an EMA is a *bona fide* asset management arrangement ("AMA"), as that term has been clearly defined by FERC.

FERC has explained AMAs as follows:

> In general, AMAs are contractual relationships where a party agrees to manage gas supply and delivery arrangements, including transportation and storage capacity, for another party. Typically a shipper holding firm transportation and/or storage capacity on a pipeline or multiple pipelines temporarily releases all or a portion of that capacity along with associated gas production and gas purchase agreements to an asset manager. The asset manager uses that capacity to serve the gas supply requirements of the releasing shipper, and, when the capacity is not needed for that purpose, uses the capacity to make releases or bundled sales to third parties.[7]

Based on this understanding of the nature of AMAs, FERC adopted regulations codifying the AMA in its capacity release rules, requiring that any capacity release pursuant to an AMA must include "a condition that the releasing shipper may call upon the replacement shipper to deliver to, or purchase from, the releasing shipper a volume of gas up to 100 percent of the daily contract demand of the released transportation or storage capacity."[8] This delivery obligation is intended to ensure that the releasing

[6] *Id.* at 48243.

[7] *Promotion of a More Efficient Capacity Release Market*, Order No. 712, FERC Stats. & Regs. ¶ 31,271 (2008), *order on reh'g*, Order No.712-A, FERC Stats. & Regs. ¶ 31,284 (2008), *order on reh'g*, Order No. 712-B, 127 FERC ¶ 61,051 (2009) *Interstate Natural Gas Association v. FERC*, D.C. Cir. August 13, 2010.

[8] 18 C.F.R. 284.8(h)(3) (2012).

shipper maintains the ability to benefit from the capacity it releases pursuant to the AMA.

Under the Commission's interpretation, it would appear that every AMA that did not impose a firm delivery obligation to or from the releasing shipper would be an option and, therefore, a swap. However, AMAs seldom bear any of the characteristics of options. For example, they generally are not severable or marketable outside of the context of the asset management arrangement. Moreover, AMAs are subject to and the product of FERC regulation.

There is no benefit to the Commission imposing swap regulations on these agreements, and the cost to the market could be significant. The arbitrary nature of treating AMA delivery obligations as swaps is highlighted by the fact that the analysis would change if the AMA delivery obligation were to be replaced with a (less efficient) right by the releasing shipper to recall capacity released to its asset manager whenever necessary. As such, market participants might behave less efficiently to avoid the unnecessary added burden of the Commission's swap regulations.

D. Infrastructure Agreements

The Commission's initial interpretation established a three-part test for determining whether or not certain physical commercial agreements, contracts, or transactions (such as infrastructure agreements) are options. Under the test, a contract will not be an option if (1) the subject of the agreement is a specified facility or part thereof (as opposed to the purchase or sale of the commodity to be created, transported, processed, or stored), (2) the agreement grants the buyer the exclusive use of the facility or part thereof during the term, and (3) payment is for the use of the facility rather than the option to use it.[9]

Although the Commission expressly excluded scheduling of interstate transmission, transportation, and storage capacity under this test, it went on to state that an agreement is an option if the right to use a specified facility is obtained through the payment of a demand charge or reservation fee, and a usage fee is paid when the facilities are actually used.[10] This would appear to suggest that almost all interstate natural gas transportation and storage service agreements are options, and therefore swaps.

To the extent that this interpretation causes transportation and storage agreements to be options and, therefore, swaps, it expands the definition of swap well beyond what the Congress intended and the CEA allows. First, transportation service agreements lack the fundamental characteristics of options. For example, unlike options, transportation and storage service agreements do not include a premium that represents the intrinsic value plus time value of the service. Moreover, the demand

[9] August 13 Order at 48242.

[10] *Supra.*

charge is not a one-time premium paid by the shipper to guarantee a strike price. In fact, the demand charge most often is paid throughout the term (usually monthly) and both the demand charge and the usage charge may be subject to change, which is completely contrary to the notion of a premium being paid to guarantee a strike price. Instead, service agreements are better understood as the purchase of a service paid for through a two-part rate specifically designed by FERC to encourage investment in pipeline infrastructure and discourage the hoarding of capacity. FERC's rate making policies generally require pipelines to charge a reservation fee that recovers all fixed costs and to charge a usage fee that covers the variable costs associated with usage. This two-part rate design does not resemble transactions commonly referred to as options, whereby a premium is paid for the right to purchase or sell something in the future at a predetermined price.

In addition, even if transportation and storage service agreements were potentially subject to the Commission's regulations under the CEA, the Commission should refrain from interpreting swaps so broadly as to unnecessarily duplicate and interfere with FERC's regulation of such contracts. While there would be no benefit derived from imposing swap reporting and position limit requirements on transportation and storage service agreements, such an interpretation would unnecessarily increase costs for commercial entities that rely on transportation and storage services. Further, such an expansion of the swap rules might drive pipelines and shippers to attempt to change the pricing of transportation and storage services in an effort to avoid the added costs of swap regulations, and such a change would harm shippers and contravene the goals that led FERC to adopt to the current two-part rate structure.

For many of the same reasons that transportation and storage agreements should not be regulated as swaps, the Commission's test should not result in tolling agreements being regulated by swaps. Where a tolling agreement involves the purchase of the right to use a specific facility, as with FERC infrastructure agreements, the Commission should not conflate a lease-type agreement or service agreement with an option based solely on the payment of a usage fee.

III. Conclusion

BGA appreciates this opportunity to comment and respectfully requests that the Commission consider the comments set forth herein.

Respectfully submitted,

/s/ Lisa Yoho
Lisa Yoho
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BG Americas & Global LNG