UNITED STATES OF AMERICA
BEFORE THE
COMMODITY FUTURES TRADING COMMISSION

Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping	)))	RIN 3038-AD46

COMMENTS OF THE
AMERICAN GAS ASSOCIATION

Pursuant to the Joint Final Rule and request for comments issued August 13, 2012,[1] by the Commodity Futures Trading Commission ("CFTC" or "Commission"), the American Gas Association ("AGA") respectfully submits these comments. AGA urges the Commission to clarify its interpretative guidance regarding how it will apply the forward contracts exclusion from swap regulations for commodity options embedded in forward contracts. In particular, AGA respectfully requests that the Commission clarify that a transaction with volumetric flexibility would not be regulated as a swap notwithstanding the fact that the parties may be able to exercise some control over whether to exercise the volumetric optionality if the overall nature of the transaction is a forward contract and the option holder's need for optionality is driven primarily by factors outside the parties' control. In addition, AGA urges the Commission to clarify that natural gas marketers and asset managers would qualify as "commercial parties" if they regularly make or take delivery of natural gas in the ordinary course of business. AGA also urges the Commission to clarify that natural gas supply transactions that provide for delivery of natural gas at points outside the continental United States are not subject to regulation as swaps regardless of whether they contain volumetric optionality. Further, AGA respectfully requests

[1] *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48,208 (Aug. 13, 2012).

that the Commission clarify that natural gas pipeline transportation and storage agreements fall within the forward contracts exclusions and are not subject to regulation as swaps, notwithstanding the fact that they commonly employ a two-part rate consisting of a monthly reservation or demand charge, and a separate usage charge.

I. COMMUNICATIONS

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II. IDENTITY AND INTERESTS

The AGA, founded in 1918, represents more than 200 local energy companies that deliver clean natural gas throughout the United States. There are more than 71 million residential, commercial and industrial natural gas customers in the U.S., of which 92 percent — more than 65 million customers — receive their gas from AGA members. AGA is an advocate for local natural gas utility companies and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international gas companies and industry associates. Today, natural gas meets almost one-fourth of the United States' energy needs. For more information, please visit www.aga.org.

AGA's members engage in financial risk management transactions in markets regulated by the Commission. As such, AGA's members will be directly affected by regulations promulgated under the Dodd Frank Wall Street Reform and Consumer Protection Act.[2]

III. COMMENTS

A. Background

As AGA has described in previous comments in this and other proceedings, AGA member gas utilities provide natural gas commodity sales and distribution service to their retail customers under rates, terms and conditions that are regulated by state commissions or other regulatory authorities. As part of performing natural gas sales and distribution functions, gas utilities develop detailed long-term plans that are subject to periodic update, review and approval processes. The purpose of these plans is to ensure that gas utilities can reliably meet the gas service needs of their customers on peak days at the lowest reasonable cost. This process includes building and managing portfolios of physical natural gas supply, and building or contracting for storage and pipeline transportation services in order to meet anticipated peak day customer needs.

On July 22, 2011, AGA filed comments in this proceeding explaining that gas utilities plan for and use a variety of physical assets to meet peak day customer demand, including peaking natural gas supply contracts such as daily supply contracts, bullet day contracts and weather contracts. These peaking supply contracts provide gas utilities with much-needed flexibility to request the delivery of volumes of natural gas on short notice to meet peak customer demands. AGA argued that the Commission should ensure that its analysis of whether a transaction is a forward contract or a commodity option embedded in a forward contract is

[2] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

sufficiently robust. In particular, AGA sought clarification that to the extent the delivery flexibility in peaking supply contracts is considered a commodity option, the transactions should nonetheless be viewed as containing commodity options embedded in forward contracts intended to be physically settled, and as such should be excluded from the definition of a "swap."

On August 13, the Commission published a joint final rule with the Securities and Exchange Commission further defining the terms "swap," "security-based swap," and "security-based swap agreement."[3] The rule provided interpretive guidance on whether certain transactions would be considered swaps. In particular, the rule provided guidance on how the Commission will apply a forward contract exclusion from swap regulations for certain commodity options embedded in forward contracts. The rule sets forth a seven-factor test to determine whether a particular transaction is a commodity option embedded in a forward contract, and thus excluded from regulation because it is not a swap.[4]

The elements of the seven-factor test are as follows: (1) the embedded optionality does not undermine the overall nature of the agreement, contract, or transaction as a forward contract; (2) the predominant feature of the agreement, contract, or transaction is actual delivery; (3) the embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded; (4) the seller of a non-financial commodity underlying the agreement, contract, or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction to deliver the underlying nonfinancial commodity if the optionality is exercised; (5) the buyer of a non-financial commodity underlying the agreement, contract or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to take

[3] 77 Fed. Reg. 48,208 (Aug. 13, 2012).
[4] *Id.* at 48,238.

delivery of the underlying nonfinancial commodity if it exercises the embedded volumetric optionality; (6) both parties are commercial parties; and (7) 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.

With regard to the seventh factor, the Commission explained that volumetric optionality would include, for example, a supply contract entered into to satisfy a regulatory requirement that a supplier procure, or be able to provide upon demand, a specified volume of a commodity.[5] The Commission added that the predominant basis for failing to exercise the option must be that the demand or supply that the option was intended to satisfy never materialized or materialized at a level different than anticipated due to physical factors or regulatory requirements outside the control of the parties.[6] The Commission further noted that it did not interpret the seventh factor to mean that absolutely all factors involved in the decision to exercise an option must be beyond the parties' control, but that the decision must be predominantly driven by factors affecting supply and demand that are beyond the parties' control, and that the embedded commodity option must be a commercially appropriate method for securing the commodity.[7]

The Commission provided further interpretations to explain how it would treat certain types of transactions. With respect to the peaking supply contracts described by AGA in its comments in this proceeding, the Commission noted that commercial operations may be such that supply and demand for a commodity cannot always be accurately predicted, and that forward contracts that allow for some optionality as to the amount actually delivered offer a great

[5] *Id.* at p. 48,238, n. 340.
[6] *Id.* at n. 341.
[7] *Id.*

deal of value to commercial participants.[8] The Commission stated the seventh factor acknowledges that the parties to transactions with embedded volumetric optionality intend to make and take delivery of the commodity, "and that it is merely the volume of the commodity that would be required to be delivered if the option is exercised, that varies."[9]

The Commission added that although the buyer has the option to specify the quantity to be delivered on any given day, there is no cash settlement alternative, and if the buyer does not exercise the right to purchase, the right is terminated.[10] The Commission noted that the option is not severable and cannot be marketed separately from the supply agreement itself. The Commission also noted that the ability of the buyer to specify the quantity to be delivered is not to encourage speculative activity but because the exact quantity of the commodity needed is unknown – "many gas purchasers have weather-dependent needs that cannot accurately be predicted in advance."[11] The Commission concluded that depending on the relevant facts and circumstances, these types of contracts may satisfy the elements of the exclusion for forward contracts with embedded commodity options, and if so would fall within the exclusion from the "swap" definition.[12]

The Commission clarified that the presence of a liquidated damages provision did not necessarily render the contract ineligible for the forward exclusion.[13] The Commission noted in particular that physically settled, natural gas peaking supply contracts use the NAESB Base Contract, which does not provide for financial settlement other than a liquidated damages provision, which would compensate the utility for its cost of obtaining alternative supplies at

[8] *Id.* at p. 48,238-39.
[9] *Id*. at p. 48,239.
[10] *Id.* at p. 48,240.
[11] *Id.*
[12] *Id.*
[13] *Id.* at p. 48,244.

prevailing market prices if the seller failed to deliver. The Commission further noted that the seller has no real opportunity to arbitrage its delivery obligation based on changes in price, and the buyer has no incentive to fail to take delivery because they are needed for the physical operations of the system. The Commission concluded that it had provided the clarification specifically to address these types of contracts.[14]

The Commission also provided an interpretation regarding certain physical commercial agreements for the supply and consumption of energy that provide flexibility, including transportation agreements on natural gas pipelines and natural gas storage agreements.[15] The Commission concluded that these agreements would not be an option if the following three elements were satisfied: (1) the subject of the agreement is usage of a specified facility or part thereof rather than the purchase or sale of the commodity that is to be created, transported, processed or stored using the specified facility; (2) the agreement grants the buyer the exclusive use of the specified facility or part thereof during its term, and provides for an unconditional obligation on the part of the seller to grant the buyer the exclusive use of the specified facility or part thereof; and (3) the payment for the use of the specified facility or part thereof represents a payment for its use rather than the option to use it.[16] The Commission noted in particular that it would not consider actions such as scheduling gas transportation or injecting gas into storage to be exercising an option if all three of these elements were met.[17] The Commission added, however, 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

[14] *Id.*
[15] *Id.* at p. 48,242.
[16] *Id.*
[17] *Id.*

analogous service charges not included in the demand or reservation fee, such agreement, contract or transaction is a commodity option subject to the swap definition."[18]

The Commission stated that its interpretation regarding forward contracts with volumetric options was an interpretation of the Commission that may be relied upon by market participants.[19] The Commission believed that it would benefit from further public comment on all aspects of its interpretation.[20] AGA commends the Commission for providing market participants with a framework for analyzing transactions that may provide for optionality as to the delivery terms and for providing interpretations as to whether certain types of transactions may be excluded from regulation because they are not swaps. In particular, AGA appreciates the Commission's interpretation with respect to physical peaking supply contracts prevalent in the natural gas industry.

AGA offers the following comments and recommendations on the seven-factor test and the interpretations included in the final rule. AGA believes that the Commission should further clarify and refine how these interpretations are to be applied to particular types of transactions, so that markets participants can have greater assurance as to whether the transactions in which they engage will be excluded from the definition of a "swap" and thus not subject to regulation by the Commission.

B. The Commission Should Clarify The Seven-Factor Test.

1. The Seventh Factor Should Not Prevent A Party From Making Cost-Effective Choices.

The seventh factor of the seven-factor test requires that the exercise or non-exercise of an option must be based primarily on physical factors or regulatory requirements that are outside of

[18] *Id.*
[19] *Id.* at p. 48,241.
[20] *Id.*

the control of the parties.[21] The Commission explained that the predominant basis for not exercising the option must be that demand for the commodity that the optionality was intended to satisfy never materialized or materialized at a level below that for which the parties contracted due to physical factors or regulatory requirements outside the parties' control.[22] The Commission added that this "does not 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.[23]

AGA agrees that not all factors influencing the decision to specify or nominate the volume of natural gas needed on a given day under the terms of the contract must be outside the control of the parties, but the predominant reason behind the need to have flexibility in the volume of natural gas that can be requested on a given day should be due to physical factors or regulatory requirements outside the parties' control. As the Commission observed, the predominant factor in the decision to take or not take delivery under physical, peaking supply, natural gas transactions that contain delivery volume flexibility is to manage weather-sensitive demands that cannot be accurately predicted in advance.[24] AGA remains concerned, however, that this factor could be construed narrowly as to defeat its intent, namely, to exempt from swap regulation physical transactions that are already transparent and pose no systemic risk to the financial system in the United States. AGA believes that the proper focus of the analysis should be on the primary need for volumetric optionality at the time the parties enter into the contract, rather than on the reason for each individual exercise of the flexibility, since the former can be shown prospectively while the latter can only be known retroactively.

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[21] *Id.* at p. 48,238.
[22] *Id.* at p. 48,238 n. 341.
[23] *Id.*
[24] *See id.* at p. 48,240.

As described above, AGA members build portfolios that include physical, natural gas supply and pipeline transportation and storage transactions in order to meet anticipated peak day customer needs. Some of the transactions in gas utility portfolios provide the utility with flexibility to request the delivery of volumes of natural gas on short notice to respond to changes in customer demand. Gas utilities enter into these types of transactions in order to have available the tools needed to respond to customer demand and to satisfy the regulatory requirement that the utility stand ready to meet the gas supply needs of its customers. As noted, gas utilities have different kinds of tools – both assets and contracts – that they can use to respond to changes in customer demand and to meet operational needs. Such tools include, among other things, peaking supply contracts (*i.e.*, transactions with volumetric flexibility), spot gas purchases, and off-system or on-system storage including liquefied natural gas (LNG) or propane air storage. In that regard, the predominant factor in a gas utility's decision to enter into a natural gas peaking supply agreement is to have natural gas supplies available as part of the utility's portfolio of assets to respond to changes in customer demand or to meet operational needs. In these circumstances, the gas utility will use reasonable business judgment, as required by its state regulators considering the timing, system operations, and customer needs, whether to exercise the delivery flexibility in any given peaking supply agreement, but ultimately, the need for volumetric flexibility under such transactions is to meet customer demand. These transactions, therefore, should satisfy the seventh factor of the Commission's seven-factor test in that the decision to enter into the transaction with volumetric optionality is predominantly based on factors outside the parties' control, *i.e.*, to meet customer demand and satisfy regulatory obligations to provide service.

The decision to exercise the volumetric optionality in any particular natural gas peaking supply transaction for any given day cannot be viewed in isolation. Since these transactions are part of a portfolio of assets all designed to serve customer demand and satisfy regulatory requirements, gas utilities have choices and thus make decisions regarding which assets to use under the particular circumstances that best meet the needs of customers at the lowest reasonable cost. On any given day, therefore, a gas utility will use a variety of supply assets in its portfolio to meet customer demand including baseload pipeline supply or storage agreements (*i.e.*, those without delivery flexibility), supply or storage agreements with delivery flexibility, or off-system or on-system storage assets. In addition, the utility may purchase gas on the spot market and have the volumes delivered to its citygate. Peaking supply transactions provide added flexibility to meet customer demand by making gas supplies available up to a maximum volume for a specific period of time.

While gas utilities have some measure of control with regard to which assets to use on any given day, the overarching purpose of holding these assets is still to meet customer demand and satisfy its regulatory obligation to provide service. In other words, a gas utility's decision not to exercise the volumetric flexibility contained in a particular transaction on a given day is still based primarily on physical factors, *i.e.*, the lack of customer demand, even when the gas utility satisfies customer demand through other means. If peak demand does not materialize on any given day, the volume delivered under a peaking supply transaction may be zero; however, if peak demand does materialize, the utility may nominate any amount up to the maximum volume allowed under the peaking supply transaction to meet the need but will consider all the circumstances and gas supply choices available to meet that demand. In some cases, the decision not to use a particular transaction to meet customer demand may be for operational reasons, such

as the need to have the supply directed to a specific location on the gas utility's system or the need to retain the supply assets for later use when customer demand is expected to be even higher. In that regard, some peaking supply contracts are tailored to meet sustained periods of high demand, while others are more tailored to meet unexpected, but short-lived, periods of high demand. Not surprisingly, price is an important factor is determining which asset to use.

Additionally, gas utilities may use asset management arrangements ("AMAs") to meet all or a portion of their customers' needs. Such arrangements may be structured in a myriad of ways, but are generally contractual relationships under which a party, typically a marketer, agrees to manage gas supply and delivery arrangements, including transportation and storage capacity, for another party. In 2008, the Federal Energy Regulatory Commission ("FERC") revised its rules to facilitate the use of AMAs.[25] FERC determined that AMAs provide significant benefits to natural gas market participants and to the marketplace in general.[26] In situations where a party turns over or "releases" pipeline transportation or storage capacity to the asset manager, FERC's regulations require that the terms of the release must contain a condition that the gas utility (the "releasing shipper") may call upon the asset manager (the "replacement shipper") to deliver a volume of gas up to 100 percent of the daily contract demand of the released transportation or storage capacity.[27] FERC's regulations further require that if the release is for one year or less, the asset manager's delivery obligation must apply on any day

[25] *See Promotion of a More Efficient Capacity Release Market*, Order No. 712, 73 Fed. Reg. 37,058 (June 30, 2008), FERC Stats. & Regs., Regs. Preambles ¶ 31,271 (June 19, 2008), *order on reh'g*, Order No. 712-A, 73 Fed. Reg. 72,692 (Dec. 1, 2008), FERC Stats. & Regs., Regs. Preambles ¶ 31,284 (Nov. 21, 2008), *order on reh'g*, Order No. 712-B, 74 Fed. Reg. 18,127 (Apr. 21, 2009), 127 FERC ¶ 61,051 (Apr. 16, 2009).
[26] Order No. 712 at P 122.
[27] *See* 18 C.F.R. § 284.8(h)(3).

during a minimum period of the lesser of five months (or 155 days) or the term of the release.[28] Thus, in the case of an AMA, there is a gas commodity delivery obligation that includes volumetric optionality in order to comply with FERC's regulatory requirements, and these AMAs are typically entered into by gas utilities as a more efficient means of utilizing various assets to meet customer demand.

AGA, therefore, contends that transactions with volumetric flexibility would satisfy the seventh factor, *i.e.*, the exercise of the volumetric optionality would be based primarily on factors outside the parties' control (to meet customer demand and satisfy regulatory requirements), even, in the case of gas supply peaking transactions where the gas utility can choose which assets or transactions to use to meet customer demand and to satisfy state regulatory requirements to meet customer needs at the lowest reasonable cost, or in the case of AMAs where the gas utility exercises the delivery obligation in order to meet customer demand or to satisfy FERC regulatory requirements regarding AMAs. The fact that a gas utility can choose which assets to use to serve customer demand or when to have an asset manager meet the delivery obligation under an AMA does not undermine the overall nature of these transactions as needed to meet customer demand – a factor outside the control of the parties. Accordingly, AGA respectfully requests that the Commission clarify that a transaction with volumetric flexibility would satisfy the seventh factor notwithstanding the fact that the parties may have some control over whether to exercise the volumetric optionality if the overall nature of the transaction is a forward contract and the need for the optionality is driven primarily by factors outside the parties' control.

[28] *See* 18 C.F.R. § 284.8(h)(3)(i).

2. Commercial Parties Should Include Marketers And Financial Entities.

Under the sixth factor of the seven-factor test, both the seller and the buyer in the transaction must be "commercial parties."[29] In the final rule, the Commission interpreted the term "commercial" in the same manner as under the Brent Interpretation.[30] The Commission clarified that under the Brent Interpretation a market participant would be a "commercial" party if it regularly makes or takes delivery of a commodity in the ordinary course of their business.[31] By way of example, the Commission explained that an investment vehicle taking delivery of gold as part of an investment strategy would not be engaging in commercial activity, but the investment vehicle would be a commercial party if it owned a gold mine and sold the output or owned a chain of jewelry stores and purchased a supply of gold.[32]

AGA believes that the Commission's restrictive view of the term "commercial" fails to take into account changes in the natural gas industry in the past several decades that have made the physical markets for natural gas far more efficient than when the Commission issued the Brent Interpretation. Legislative and regulatory changes in the 1970's and 1980's, such as producer price deregulation, open access transportation on interstate pipelines, and retail competition, have resulted in the increased efficiency and competitiveness of the natural gas market and overall lower prices for natural gas to consumers.[33] In 1992, FERC found the

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[29] 77 Fed. Reg. at p. 48,238.
[30] *See id.* at p. 48,238 n. 338, referencing pp. 48,228-29, and *Statutory Interpretation Concerning Forward Transactions*, 55 Fed. Reg. 39,188 (Sep. 25, 1990), Comm. Fut. L. Rep. (CCH) ¶ 24,925 (Sept. 25, 1990) ("*Brent Interpretation*").
[31] 77 Fed. Reg. at p. 48,229.
[32] *Id.*
[33] *See Regulation of Short-Term Natural Gas Transportation Services and Regulation of Interstate Natural Gas Transportation Services*, Order No. 637, 1996-2000 FERC Stats. & Regs., Regs. Preambles ¶ 31,091 (2000), *order on reh'g*, Order No. 637-A, 1996-2000 FERC Stats. & Regs., Regs. Preambles ¶ 31,099 (2000), *order denying reh'g*, Order No. 637-B, 92

existence of a competitive market for natural gas sales for resale, and to further such competition FERC granted blanket authorization to all persons that are not interstate pipelines to make sales for resale of natural gas in interstate commerce at negotiated or market-based rates.[34] Subsequently in 2000, FERC noted that the natural gas markets had matured further to provide customers with even more choices.[35] Of particular note was an increase in the number of new participants in the wholesale markets. According to FERC, "the industry ha[d] witnessed a dramatic growth in the use of marketers to provide gas, arrange transportation, or provide both services to LDCs, industrials, end users, and electric generators."[36] FERC observed that gas utilities that hold firm transportation capacity on a single interstate pipeline may use marketers to obtain and deliver gas to an interconnection point on that pipeline, while other customers, such as industrials, may use marketers to acquire gas and interstate transportation capacity to deliver the gas to the industrial's plant.[37] The effect of these changes has been to enlarge the purchasing options for gas buyers thus increasing competition and putting downward pressure on natural gas prices for consumers.

FERC also recognized that marketers had begun to provide asset management services that assist customers, and that such arrangements were beneficial to the natural gas marketplace. As noted above, FERC revised its existing rules in 2008 to make certain clarifications that would facilitate the use of AMAs.[38] FERC determined that AMAs provide significant benefits to

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FERC ¶ 61,602 (2000), *aff'd in relevant part sub nom. Interstate Natural Gas Ass'n of Amer. v. FERC*, 285 F.2d 18 (D.C. Cir. 2002).

[34] *See Regulations Governing Blanket Marketer Sales Certificates*, Order No. 547, 1991-1996 FERC Stats. & Regs., Regs. Preambles ¶ 30,957 (1992) (codified at 18 C.F.R. § 284.402).

[35] Order No. 637, *supra* n. 33 at p. 31,250.

[36] *Id.* at p. 31,252.

[37] *Id*.

[38] *See* Order No. 712, *supra* n. 25.

natural gas market participants and to the marketplace in general.[39] AMAs allow gas buyers to use third-party experts to manage their gas supply arrangements and pipeline capacity holdings to lower gas supply costs and more efficiently use the pipeline grid. In particular, FERC found that "[a]sset managers have resources and market knowledge not necessarily available to natural gas capacity holders, such as trading platforms, credit portfolios, hedge fund and risk management experience, cost containment and counterparty credit and contracting expertise, which allow asset managers to better maximize the value of the releasing party's assets and manage the associated risk."[40] FERC concluded that AMAs benefit the natural gas market by increasing the efficient utilization of pipeline transportation and storage capacity.

Today, there are numerous entities in the natural gas marketplace that buy and sell natural gas. AGA believes that it would be unnecessarily limiting and potentially disruptive to the market to restrict the types of entities that gas utilities and other market participants can contract with for physical supplies by only allowing certain entities to be considered "commercial parties" for purposes of the seven-factor test. In recognition of the current structure of today's natural gas market and the numerous entities that are counterparties for natural gas purchase and sales transactions, AGA contends that the term "commercial" should not be viewed so narrowly as to eliminate marketers and asset managers as "commercial parties" for purposes of the seven-factor test if they do not own production or distribution assets. As described above, these entities provide enormous benefits to natural gas market participants and the market as a whole, and are essential to the efficient functioning of the natural gas market. If they are determined not to be commercial parties for purpose of the seven-factor test, not only would it potentially result in a loss of liquidity in the physical markets, thereby increasing costs to consumers, it would also

[39] *Id.* at P 122.
[40] *Id.*

deny the natural gas market the expertise and innovative product offerings that have increased the efficiency of the natural gas market. AGA believes that the CFTC should not be taking steps that discourage the use of AMAs while FERC regulations are actively promoting them, as this would likely be extremely disruptive to the current natural gas market.

AGA believes that natural gas marketers and asset managers should qualify as "commercial parties" for purposes of the sixth factor of the seven-factor test. Like other producers, sellers, and other entities holding FERC blanket marketing authorizations, natural gas marketers and asset managers have been regularly making or taking delivery of natural gas in the ordinary course of their gas marketing and asset management businesses. The Commission should not now also require them to own production or distribution assets in order to qualify as "commercial parties" so that their transactions with volumetric optionality may be exempt from swap regulation under the seven-factor test. Accordingly, AGA urges the Commission to clarify that natural gas marketers and asset managers qualify as "commercial parties" under the sixth factor of the seven-factor test if they regularly make or take delivery of natural gas in the ordinary course of business.

3. The Commission Should Clarify The Application Of The Seven-Factor Test To Transactions That Occur Outside the United States.

The natural gas market is integrated across the entire North American continent. As a result, AGA members may purchase natural gas under agreements with volumetric optionality where the delivery point for the sale is in Canada. In many cases the natural gas is transported into the United States for consumption, but in other cases the gas may remain in Canada. It may be moved into a Canadian storage facility for later delivery to the U.S. or it may be resold into the Canadian natural gas market. AGA contends that the Commission should not regulate transactions with volumetric optionality where delivery under the contract occurs outside the

United States. Gas utilities should be able to continue to source their natural gas supply needs in Canada, including through the use of peaking supply contracts, without having such transactions subject to swap regulation by the Commission. Indeed, AGA sought and obtained similar clarification regarding the treatment of international gas purchase and sales transactions from FERC when that agency required greater transparency in the natural gas market. In 2007, FERC revised its regulations to require natural gas market participants to annually report information regarding their wholesale, natural gas transactions.[41] In doing so, FERC clarified that transactions where the natural gas volumes originated outside the continental U.S. and are delivered outside the continental U.S. are not subject to the reporting requirement.[42] Accordingly, AGA respectfully requests that the Commission clarify that natural gas supply transactions that provide for delivery of natural gas at points outside the continental United States are not subject to regulation as swaps regardless of whether they contain volumetric optionality.

C. The Commission Should Clarify That Gas Transportation And Storage Agreements Are Not Swaps.

In the final rule, the Commission provided an interpretation regarding natural gas pipeline transportation and storage agreements, concluding that such agreements would not be considered options, and therefore would not be regulated as swaps, if they satisfied a three-part test.[43] The Commission added, however, that if the right to use the facility is only obtained

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[41] *Transparency Provisions of Section 23 of the Natural Gas Act*, Order No. 704, 73 Fed. Reg. 1,014 (Jan. 4, 2008), FERC Stats. & Regs., Regs. Preambles ¶ 31,260 (Dec. 26, 2007), *order on reh'g and clarification*, Order No. 704-A, 73 Fed. Reg. 55,726 (Sep. 26, 2008), FERC Stats. & Regs., Regs. Preambles ¶ 31,275 (Sep. 18, 2008), *order dismissing reh'g*, Order No. 704-B, 125 FERC ¶ 61,302 (Dec. 18, 2008), *order granting clarification*, Order No. 704-C, 75 Fed. Reg. 36,632 (June 23, 2010), 131 FERC ¶ 61,246 (June 17, 2010).
[42] *See* Order No. 704-A at P 74, Order No. 704-C at P 26.
[43] 77 Fed. Reg. at p. 48,242.

through the payment of a demand charge or reservation fee, and the exercise of the right to use the facility entails the further payment of actual storage fees, usage fees, rents, or other analogous service charges not included in the demand or reservation fee, then the agreement would be considered a commodity option and thus would be subject to regulation as a swap.[44] Gas utilities purchase natural gas transportation and storage services in order to bring gas supplies to their systems for redelivery to retail customers. In addition, many gas utilities provide gas transportation and storage services separate from the bundled, retail, gas services they provide to retail customers. These services are most often regulated by a state commission for the state in which they are provided. In some cases, these services are provided to customers in interstate commerce and thus are regulated by FERC.

AGA contends that natural gas pipeline transportation and storage agreements should not be regulated as swaps. As more fully explained below, natural gas transportation and storage agreements should be viewed as forward contracts excluded from Commission regulation because they are physical gas market arrangements inextricably tied to the delivery of physical natural gas to wholesale customers or retail, end-users.[45] These services are provided pursuant to tariffs on file with the FERC and regulated under the Natural Gas Act or with a state commission and regulated under state law. Under these agreements, physical delivery is scheduled (or deferred) consistent with operational or regulatory requirements that affect market demand and supply for the gas itself. Moreover, the two-part rate structure common for these transactions is based on FERC's or the state commission's regulatory requirements and compensates the transportation or storage provider for the costs of providing the service. The purpose of the two-

[44] *Id.*
[45] *See The Evolution of Federal Regulatory Policy, Contracting and Trading Practices for Natural Gas in the United States,* 19 Nat. Gas Cont. Newsl. 1, 15 (May 2003).

part rate is not, as the Commission states in the above-cited analysis, to give parties an option that establishes legal rights to use a specified transportation or storage facility as of the time usage fees are paid. Accordingly, AGA respectfully requests that the Commission clarify that natural gas transportation and storage agreements fall within the forward contracts exclusion and thus are not subject to regulation as swaps.

1. Gas Transportation And Storage Agreements Are Inextricably Tied To The Scheduling And Physical Delivery of Natural Gas.

AGA contends that natural gas transportation and storage agreements fall within the forward contracts exclusion articulated in the final rule because they are customary commercial agreements for tariff-based services that are entered into for the commercial purpose of physically delivering natural gas to wholesale customers or retail, end-users. AGA urges the Commission to consider that the economic function of these agreements appropriately distinguishes them as physical contracts rather than commodity options because they are long-standing tools for the movement of a physical commodity.[46]

For gas utilities as well as other market participants, the rates, terms and conditions of the transportation and storage services provided under these agreements are structured for the use of a given facility's capacity to deliver gas based on reasonable commercial expectations. These physical agreements have a distinct economic function as compared to financial trading arrangements wherein neither the buyer nor the seller stands ready to execute physical delivery of the gas, as well as from hybrid contracting mechanisms that employ physical forward delivery

[46] *See Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options,* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,718 at p. 31,028 (CFTC Sept. 30, 1985) (citing *CFTC v. Precious Metals Associates*, 620 F.2d 900, 908 (1st Cir. 1980) ("The courts and the Commission have carefully examined 'the economic reality of the transaction, not its name' to determine whether an instrument is an option.") ("*1985 Interpretive Statement*").

and take obligations that may be converted and performed as financial swap transactions.[47] By analogy, an agricultural produce trucking and refrigeration business cannot make or lose money without actually delivering the underlying commodity in its shipping containers or storage facilities; likewise, the natural gas transportation and storage system neither incurs gains nor losses unless it stands ready to deliver physical natural gas.

AGA recognizes that the Commission may have some concerns about the cross-market effects of transactions taking place in the physical and financial gas markets, such as marketing functions that take place in both the physical and financial markets. Indeed, marketers buy and sell physical volumes sufficient to secure supplies of natural gas needed by wholesale customers and end-users in physical markets, while hedging purchases and sales transactions with long and short financial positions in financial markets. In both cases, marketers take title to the natural gas and assume market and counterparty risks. However, in the physical markets, bilateral contracts to secure gas require the arrangement of gas storage and transportation services for the delivery of the gas, agreements that do not function in the absence of an intent to deliver physical natural gas.

To the extent that some service agreements entail the transfer of price risk associated with the gas commodity, the Commission should consider that all of these price risks are inextricably linked to and dependent on the physical movement of the gas itself, and that their economic purpose is not to provide an arena for transferring price risk among market participants. More

[47] *In the Matter of Cargill, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 28,425 (Nov. 22, 2000) ("Starting in the 1980s commercial parties began experimenting with a variety of new risk management instruments, including contracts which combined forward elements with option and security-like components in varied and complex ways. New "hybrid" contracts emerged to fill market needs not met by existing forward and futures contracts. Since these contracts broke the old molds, they raised new challenges for the Commission and the courts as they struggled to place them in the proper regulatory pigeonholes.").

simply, market participants contracting for transportation and storage of natural gas enter into these transactions to provide for the movement of gas, not to protect their financial interests against adverse gas price movements. Sourcing and scheduling decisions made under these contracts, and any gains or losses from gas price movements related to these decisions, reflect a combination of regulatory and physical requirements to move gas when and where it is needed.

The Commission and the courts have consistently used an analysis for classifying instruments as forwards or options that is based on commercial practice, the economic nature of the contract, and contract law and precedent.[48] The analysis for natural gas transportation and storage agreements should be no different, and should lead to the logical conclusion that any price risk transfers associated with these transactions are incidental to the inherently physical nature of these agreements.

Natural gas transportation and storage agreements also meet the multi-factor analysis discussed by the Commission in its Brent Interpretation.[49] Consistent with the Brent Interpretation and Commission precedent,[50] gas transportation and storage contracts are entered into: (i) for commercial purposes in connection with economic demand arising within the ordinary course of business in physical gas markets; (ii) their impacts on future gas price risks are incidental to the underlying commercial arrangement to move gas supplies; (iii) parties to the agreements are obligated to comply with terms and conditions set in regulated tariffs that require

[48] *1985 Interpretive Statement, supra*, n. 46 at p. 31,027-28, (stating that "[t]o determine whether an instrument is an option or forward, both the Commission and the courts have examined pre-existing contract law, commercial practice and the economic nature of the contract") (citing *CFTC v. Precious Metals Associates*, 620 F.2d at 907-908; *British American Commodity Options Corp. v. Bagley*, 552 F.2d 482, 484-485 nn. 4, 5 (2d Cir. 1977); *CFTC v. Goldex Int'l Ltd.*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,839 at p. 23,441 (1979).

[49] *See Brent Interpretation*, Comm. Fut. L. Rep. (CCH) ¶ 24,925 at pp. 37,366-68; *see also In the Matter of Cargill, Inc.*, at p. 28,432.

[50] *In re Stovall*, Comm. Fut. L. Rep. (CCH) ¶ 20,941, at p. 23,780 (Dec. 6, 1979).

them to have the capacity to make or take delivery of the gas; (iv) with respect to interstate transportation or storage contracts, the re-assignment of obligations (capacity release) under these contracts is subject to FERC policy as well as the terms and conditions in the tariff; and (v) the contracts are not subject to variation margining or a clearinghouse/settlement system. Most importantly, these contracts are executed with the expectation that delivery of the actual commodity will eventually occur through performance on the contract.[51]

For these reasons, natural gas transportation and storage agreements satisfy the critical element of the forward contract exclusion in that they are intended to be settled physically. AGA contends that the Commission should require nothing more for these transactions to qualify for the forward contracts exclusion. Accordingly, AGA respectfully requests that the Commission clarify that all natural gas storage and transportation agreements fall within the scope of the forward contracts exclusion and are thus not subject to regulation as swaps.

2. Two-Part Natural Gas Transportation And Storage Rates Do Not Reflect Optionality.

AGA also contends that natural gas transportation and storage agreements fall within the forward contracts exclusion, notwithstanding that they commonly employ a two-part rate consisting of a monthly reservation or demand charge, and a separate usage charge, because the two-part rate compensates the transportation or storage provider for the costs of providing the service and does not reflect the right to exercise an option. In wholesale, natural gas transportation and storage markets, a two-part rate that includes a reservation or demand charge and a usage charge is based on FERC's regulatory requirements related to charging a "just and

[51] *Brent Interpretation*, Comm. Fut. L. Rep. (CCH) ¶ 24,925 at pp. 37,367-68.

reasonable" rate pursuant to Section 4 of the Natural Gas Act.[52] Similarly, for intrastate transportation two-part or multi-part rates are based on the regulatory requirements of the applicable state regulatory authority under a natural gas utility's transportation tariff.

In 1992, FERC undertook a major restructuring of the natural gas markets, including a review of pipeline transportation and storage rate design, in order to take advantage of natural gas price competition and to ensure that all shippers have access to the pipeline transportation grid to transact the most efficient deals possible.[53] As relevant here, FERC required pipelines to design their rates using a straight fixed-variable ("SFV") rate design, under which all of the fixed costs required to provide a service were to be recovered in a monthly reservation or demand charge while all of the variable costs associated with the service were to be recovered in a usage charge.[54] FERC adopted the SFV rate design to promote competition among gas suppliers by eliminating price distortions created by alternative rate designs that allocated a portion of the pipeline's fixed costs to the variable usage charge.[55] FERC considers the SFV rate design to be "just and reasonable" because the usage fees paid under this rate design reflect only the increased costs incurred by the pipeline for the volume of service actually rendered to the shippers. The

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[52] Natural Gas Act § 4(a), 15 U.S.C. § 717c(a) ("All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the [FERC], and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is declared to be unlawful.").

[53] *See Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, Order No.636, January 1991-June 1996 FERC Stats. & Reg., Regs. Preambles ¶ 30,939 (1992), *order on reh'g*, Order No. 636-A, January 1991-June 1996 FERC Stats. & Regs., Regs. Preambles ¶ 30,950 (1992), *order on reh'g*, Order No. 636-B, 61 FERC ¶ 61,272 (1992), *reh'g denied*, 62 FERC ¶ 61,007 (1993), *aff'd in part and remanded in part sub nom., United Distrib. Cos. v. FERC*, 88 F.3d 1105 (D.C. Cir. 1996), *order on remand*, Order No. 636-C, 78 FERC ¶ 61,186 (1997).

[54] Order No. 636 at p. 30,434.

[55] *Id.*

more a pipeline is used, the more certain costs are incurred, such as increased maintenance expenses. Under FERC regulations, SFV rate design is required for all jurisdictional transportation and storage services unless specifically permitted otherwise.[56]

Even where FERC authorizes a pipeline to design rates using an alternative rate design methodology that includes some fixed costs in the usage charge, the two-part rate still functions to compensate the pipelines for all the costs of providing the service. In like manner, the rates for natural gas transportation and storage services provided by gas utilities, where the services are regulated by either FERC or a state commission, are designed to compensate the pipeline or storage provider for the allocated costs of providing such services. In all cases, two-part or multi-part rates function to recover "just and reasonable" costs; usage charges do not function to reflect a shipper's "option" to use the service.

Accordingly, AGA respectfully requests that the Commission clarify that natural gas transportation and storage agreements are within the forward contracts exclusion, notwithstanding the fact that they commonly employ two-part or multi-part rates. Specifically, AGA urges the Commission to declare that two-part or multi-part rates for natural gas transportation and storage services that provide for the physical delivery of natural gas to wholesale customers or end-users represent payment for the use of the transportation and storage facilities, rather than payment for the option to use such facilities. In that regard, AGA respectfully requests that the Commission acknowledge that the usage fee of a typical two-part rate for natural gas transportation or storage service that provides for the physical delivery of natural gas does not reflect the exercise of an option or the right to use such transportation or storage facilities.

[56] *See* 18 C.F.R. § 284.7(e).

IV. CONCLUSION

In sum, the American Gas Association respectfully requests that the Commission: (1) clarify that a transaction with volumetric flexibility would not be regulated as a swap notwithstanding the fact that the parties may be able to exercise some control over whether to exercise the volumetric optionality if the the overall nature of the transaction is a forward contract and the option holder's need for optionality is driven primarily by factors outside the parties' control; (2) clarify that natural gas marketers and asset managers would qualify as "commercial parties" if they regularly make or take delivery of natural gas in the ordinary course of business; (3) clarify that natural gas supply transactions that provide for delivery of natural gas at points outside the continental United States are not subject to regulation as swaps regardless of whether they contain volumetric optionality; and (4) clarify that natural gas pipeline transportation and storage agreements fall within the forward contracts exclusions and are not subject to regulation as swaps, notwithstanding the fact that they commonly employ two-part or multi-part rates consisting of a monthly reservation or demand charge, and a separate usage charge.

Respectfully submitted,

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