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 TEXAS PIPELINE 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 Texas Pipeline Association ("TPA") respectfully submits these comments. TPA respectfully requests that the Commission clarify that natural gas service agreements, such as bundled sales of delivered natural gas and natural gas storage and pipeline transportation[2] agreements provided by intrastate pipelines, fall within the forward contracts exclusion and are not subject to regulation as swaps.

Background

The TPA is an organization of forty natural gas and liquids intrastate pipeline companies operating in the State of Texas. Many of the TPA's members operate in other states as well. The TPA's members gather, process, treat, transport, store and deliver natural gas and liquids for their customers, which include producers, marketers, commercial and industrial end-users, other pipelines, and distribution companies. The TPA member companies engage in the transportation, storage and sale of natural gas, and their intrastate activities are subject to the jurisdiction of the Texas Railroad Commission and other state commissions. In addition, TPA members may provide transportation and storage services in interstate commerce pursuant to Section 311 of the Natural Gas Policy Act of 1978[3], and subject to regulation by the Federal Energy Regulatory Commission.[4]

When providing transportation and storage services, TPA member pipelines do not take title to the gas but simply transport and store the commodity on behalf of their customers, which may include local distribution companies, gas marketers, electric generation facilities, and industrial or commercial end users. Some TPA members also provide bundled sales services to their customers. In a bundled sale, the pipeline owns the gas, transports it to, for example, a local distribution company or industrial end user, and sells the gas to the customer at the point of delivery.[5] The rate paid by the bundled

[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).
[2] Transportation includes all movement of natural gas (e.g., gathering, interstate transport, distribution) on any pipeline system.
[3] 15 U.S.C. § 3371.
[4] 18 C.F.R. § 284.121, *et. seq.*
[5] Hereinafter, service agreements for natural gas transportation and storage services and bundled sales of delivered natural gas shall be referred to as "Natural Gas Service Agreements."

sale customer includes both the cost of transportation and the price of the gas. Because the customer may not need its full contract quantity every day depending on weather, operating conditions, or other factors, the volume of transportation and storage service or commodity purchased by the customer may vary from day-to-day.

CFTC's Historical Precedent and Interpretations Support TPA's Position that Natural Gas Service Agreements Are Not Swaps

Natural Gas Service Agreements do not have the characteristics of CFTC-jurisdictional swaps or futures as those terms have been statutorily defined and interpreted in CFTC precedent and the Joint Final Rule.

The Commodity Exchange Act ("CEA"), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act defines "swap," in summary terms as any agreement, contract, or transaction:

- that is a put, call, cap, floor, collar or similar option ("option");
- that provides for the purchase, sale, payment, or delivery that is dependent on the occurrence or nonoccurrence of an event associated with a commercial consequence;
- that provides for the exchange of payments based on the change in value of certain assets without conveying a current or future ownership interest in the asset (e.g., interest rate swap, equity swap, weather swap, energy swap).[6]

The CEA also provides that any sale of a nonfinancial commodity that is intended to be physically settled is not a swap. [7] Natural gas transportation and storage services and bundled sales are not options, and the delivery of gas under these agreements is not tied to the occurrence or nonoccurrence of an event associated with a commercial consequence. The principle purpose of these agreements is to physically move gas one from place to another on behalf of a customer or to physically deliver gas for sale to a customer at its distribution facility or industrial plant. The payment for these services is not based on the change in value in any give asset. Thus, bundled sales of delivered natural gas and natural gas pipeline transportation and storage agreements, do not meet the definitions of "swap" or "future" and fall under the statutory exclusion for physically settled sales on non-financial commodities.

Concluding that Natural Gas Service Agreements do not have the characteristics of options is also consistent with CFTC precedent. As set forth in the *1985 Interpretive Statement*, in determining whether an agreement is an option, the Commission and courts "have carefully examined 'the economic reality of the transaction, not its name.'"[8] As explained in *In the Matter of Cargill*:

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[6] CEA Section 1a(47)(A).
[7] CEA Section 1a(47)(B)(ii).
[8] *1985 Interpretative Statement* at p. 22,718.

> The *1985 Interpretative Statement* identifies three criteria indicative of an option. First, the instrument gives the buyer the right to take or make delivery of the commodity but does not obligate him to do so. Second, the buyer's losses are limited to a premium paid as consideration for the option seller's performance. Third, the instrument is purchased by offering a premium as opposed to a down payment on the eventual delivery price.[9]

Natural Gas Service Agreements do indeed include an obligation to make or take delivery, and they do not include any kind of premium payment for a right to the contracted services. The payment exchanged between the parties in these kinds of transactions is directly related only to the service or, in the case of a bundled sale, the service and commodity provided.

TPA maintains that the CEA's definitions as well as the application of the Commission's "facts and circumstances" test and "economic reality" test demonstrate that contracts for natural gas services, such as bundled sales of delivered natural gas and natural gas pipeline transportation and storage agreements, are not swaps or futures subject to the jurisdiction of the CFTC. In addition, as discussed in more detail below, Natural Gas Service Agreements also satisfy the CFTC's latest interpretive guidance in the Joint Final Rule as to when forward contracts with embedded volumetric optionality will not be considered swaps.

BUNDLED SALES OF GAS AND TRANSPORTATION QUALIFY FOR EXCLUSION

In the Joint Final Rule, the CFTC provided an interpretation that forward contracts with embedded optionality will not be considered swaps, if they satisfy the elements of a seven-part test. TPA submits that its members' bundled sales satisfy the elements of the seven-part test for exclusion from the swap and future definition. Notwithstanding this, TPA submits that the CFTC should make certain clarifications to the seven-part test to more clearly express its intent that forward contracts with embedded volumetric optionality, like bundled sales, are excluded from the swaps and future delivery definitions.

The Joint Final Rule sets forth the following seven-part test for determining whether a forward contract with embedded volumetric optionality falls within the forward exclusion.

> "Accordingly, the CFTC is providing an interpretation that an agreement, contract, or transaction falls within the forward exclusion from the swap and future delivery definitions, notwithstanding that it contains embedded volumetric optionality, when:

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[9] *In the Matter of Cargill*, at p. 28,425.

> 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 nonfinancial 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 nonfinancial 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 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."[10]

A review of each factor demonstrates that bundled sales of natural gas meet the standards set out in the seven part test and are excluded from the rule. The ability of the consumer to vary takes is part and parcel of a contract for the firm delivery of natural gas to a customer whose usage may vary. The predominant feature of the contract is actual delivery of natural gas to meet the customer's needs. The ability to vary the amount of gas taken is not severable or separately marketable from the contract. The seller, in this case an intrastate natural gas pipeline, is bound by the contract to deliver the amount of gas required by the customer. The buyer, by entering into a contract for delivery of natural gas, intends to take delivery of the quantity necessary to meet its needs. Both the seller, the intrastate natural gas pipeline, and the buyer, either a local distribution company or industrial or commercial user of gas, are commercial parties. Finally, the volume of gas taken is generally based on physical factors or regulatory requirements beyond the control of the parties. Thus, bundled sales of natural gas meet the Commission's seven-part test.

Nevertheless, TPA requests one modification or clarification. The seventh factor states that the exercise or a non-exercise of an option should be based on physical factors or regulatory requirements that are outside the parties' control and are influencing demand for, or supply of, a nonfinancial commodity. As a threshold matter, TPA submits that the seventh factor should be deleted because focusing on why the optionality was exercised does not answer the fundamental question of whether contract is a forward or an option. An examination of the motivation behind the exercise or nonexercise of a volumetric option is not relevant or necessary as long as there is an intent to physically

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[10] *Id.* at 48238.

deliver the service or commodity. Furthermore, asking a pipeline, the seller of the transportation and gas, to determine why its customer may exercise optionality in order to determine whether the pipeline satisfies the forward contract exclusion is not reasonable or practical. When TPA members enter into bundled sales contracts with their customers they do not need to know why the customer may exercise the volumetric optionality. Pipelines and their customers should not be required to ascertain each other's motives in a contract in order to obtain regulatory assurance that the contract is not a swap.

If the CFTC determines that the seventh factor should not be deleted, then it should at least clarify this factor to reduce regulatory uncertainty. While it is true that customer takes are generally driven by external factors outside of the control of the parties, such as weather, or demand for the output of an industrial or commercial end user, there may be circumstances in which a buyer has some control over the volume it takes from a given supplier. The volume may depend on overall supply available to that customer, needs at a specific location that has connections to multiple supplies, or production decisions by an end user based on economic conditions having nothing to do with the natural gas contract. Thus, if the seventh factor is not deleted, the Commission should clarify that the seventh factor is satisfied even if the parties have some limited control over whether to exercise the volumetric optionality because the overall level of demand is set by physical factors which influence demand for natural gas.

NATURAL GAS TRANSPORTATION AND STORAGE CONTRACTS ARE EXCLUDED CONTRACTS

A firm natural gas transportation and storage contract generally provides for a two part rate. The amount paid to reserve the capacity is called a reservation or demand charge, often this amount will reflect all of the pipeline's fixed costs, and constitutes the bulk of the amount paid. Once a shipper commits in an executed contract to pay the demand charge, it has the absolute right to have its gas transported by the pipeline. If gas is shipped, the shipper will, after the gas is transported, pay a usage charge, which typically reflects the pipeline's variable costs, and reimburse the pipeline for fuel and lost and unaccounted for gas. These latter charges, usually a small fraction of the total charge, reimburse the pipeline for the costs incurred in actually moving the gas through the pipe; these are not "option" payments made to perfect the shipper's right to use the capacity. Upon payment of the demand charge, the pipeline is obligated to transport the gas and the shipper is not entitled to any refund of the demand charge if it chooses not to use the capacity it has reserved. Importantly, the shipper is bound as well as the pipeline and both parties must routinely perform and face the full risk of loss.

The Joint Final Rule provided an interpretation regarding certain physical commercial agreements for the supply and consumption of energy, including transportation agreements on natural gas pipelines and natural gas storage agreements.[11] The Commission concluded that these agreements would not be an option if the following three elements were satisfied:

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[11] *Id.* at 48242.

(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.[12]

The Commission also noted that it would look to the facts and circumstances as a whole to determine whether a particular contract is a forward. The Commission stated 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.[13] Natural gas storage and transportation contracts meet the three part test and thus are not options under the three-part test. But, the Commission added:

> 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.*[14]

It is this "However" paragraph that appears to bring most natural gas storage and transportation contracts back into the definition of a swap (as a commodity option) by creating a bright line test focused solely on the structure of the rate for service without regard to the facts and circumstances or associated economic realities. The TPA is providing these comments so that the CFTC is aware of, and can correct, the confusion created by the "However" paragraph, which on its face deems contracts to be options that in reality are forwards.

THE COMMISION SHOULD ELIMINATE THE UNCERTAINTY CREATED BY THE 'HOWEVER'PARAGRAPH

Natural gas transportation and storage contracts are not and have never heretofore been considered to be options. As noted above, in determining whether an agreement is an option, the Commission and courts "have carefully examined '*the economic reality of the transaction, not its name*.'"[15]

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[12] *Id.*
[13] *Id.*
[14] *Id.* (emphasis added).
[15] *Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) P 22,718 (Sept. 30, 1985) (emphasis added) ("*1985 Interpretative Statement*"). The *1985 Interpretive Statement* was issued by the Commission's General Counsel, but "has been consistently cited by both the Commission and courts as persuasive authority on the topics that it

Natural gas transportation and storage contracts do not meet the definition of an option (even without any application of the above discussed three-part test). The payment of the usage fee is not the same as exercise of an option to use capacity. Generally speaking, there are two types of gas transportation and storage contracts, firm and interruptible. An interruptible contract generally provides for the payment of a single rate per unit of through put. This is a simple pay as you go commercial agreement. As explained earlier, a firm contract may include a multi-part rate, but the pipeline remains bound to receive and deliver the contract quantity negotiated by the shipper and the shipper must pay the demand charge, generally the bulk of the total rate paid, regardless of whether it ships any gas.

The Commission appeared to correctly recognize that natural gas transportation and storage contracts are not options. The Commission provided an interpretation regarding physical agreements specifically including transportation agreements on natural gas pipelines.[16] The transportation and storage activities of TPA members meet this three part test. TPA member contracts provide for the usage of a specified facility or part of the facility; the agreement grants the shipper the exclusive use of the portion of the facility necessary to meet the buyer's demand and the payment by the buyer is for the use of the facility.

The "However" paragraph's multi-part rate interpretation was never discussed in the notice of proposed rulemaking and TPA and other members of the natural gas industry had no notice of this interpretation. This paragraph appears to reverse everything that came before it and renders transportation and storage contracts with anything other than a one part rate as commodity options. This interpretation departs from the three-part test immediately preceding it, as well as from the Commission's traditional approach to examining forward contracts based on the "facts and circumstances" and options based on the "economic reality" of the transaction.[17]

Gas transportation and storage contracts depart materially from the characteristics of an option. Firm transportation and storage contracts obligate the shipper to pay the reservation fee for the duration of the contract; the reservation fee is neither a limited-risk premium, nor a right or option to later purchase the right to use the specified capacity; the right to use the specified amount of capacity for the term of the contract is legally established upon signing the contract; and the payment of the usage fee is not the expense of an option. The bulk of the amount paid to the pipeline is generally included in the demand charge. The actual use of the facility does not depend on the further exercise of an option. The usage fee, which is billed after gas actually flows, allows the pipeline to recover its variable costs of providing the service (i.e., moving the gas through the

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addresses." *In the Matter of Cargill*, [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) P 28,425 n.28 (Nov. 22, 2000) (citing authority), *aff'd mem.*, Comm. Fut. L. Rep. (CCH) P 29,633 (Nov. 25, 2003).

[16] *Id.*

[17] An agency's unexplained departure from its own precedents is reversible error. *See e.g., Transmission Agency of N. Cal v. FERC*, 495 F. 3d 663, 672 (D.C. Cir. 2007).

pipeline if gas is scheduled). The usage fee is not a premium paid for the pipeline's performance and often represents only a fraction of the overall payment.

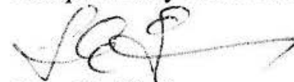
The "economic reality" of firm transportation and storage contracts is different than the economic reality of a commodity options. There is no shifting of any economic risk. The demand charge and the usage fee are not paid to allow the shipper to shift any economic risk. Unlike a commodity option premium, risk of loss is not shifted to the pipeline and no benefit of favorable price movements or loss limitation is provided to the shipper.

Thus, transportation and storage contracts should not be subject to regulation as swaps solely based on the payment structure of the transactions. Typical transportation and storage contracts do not bear the characteristics of options, and treating them as options pursuant to the bright-line test set out in the "However" paragraph vitiates the three part test which was apparently intended to govern natural gas transportation contracts.

Conclusion

Accordingly, the TPA requests that the Commission (1) delete, or in the alternative, clarify the seventh factor of the test for whether a forward contract with embedded optionality is not a swap; and (2) either rescind the "However" paragraph, or clarify that it was not intended to classify as options, natural gas service agreements, such as transportation and storage contracts, that otherwise satisfy the Commission's three part test.

Respectfully submitted,



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