



October 12, 2012

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

Re: Comments of Encana Marketing (USA) Inc. on Certain Interpretations Made in the Final Rule Further Defining "Swap," RIN Number 3038-AD46

Dear Ms. Yochum:

Encana Marketing (USA) Inc. (EMUS) hereby files these comments on two of the interpretations made by the Commodity Futures Trading Commission (Commission) in the Final Rule further defining the term "swap."¹

I. Introduction

EMUS is an indirect, wholly-owned subsidiary of Encana Corporation (Encana). Its principal United States (U.S.) office is located in Denver, Colorado. EMUS' marketing activities include selling and purchasing natural gas, natural gas liquids, other related energy commodities and services in the U.S. wholesale energy markets.

As part of EMUS' marketing activities, Encana, for itself and its subsidiaries, enters into hedging transactions or swaps to manage and mitigate commercial risks associated with EMUS' sales, purchases and movement of these energy commodities. It considers itself to be a non-financial commercial end-user of swaps under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). EMUS also utilizes transportation and storage services on a number of interstate and intrastate pipelines and gathering systems to move these energy commodities throughout the U.S.

II. Comments

EMUS' comments focus on two of the interpretations made by the CFTC in the Final Rule: (1) the CFTC's interpretation regarding forward contracts with embedded volumetric optionality; and (2) the CFTC's interpretation regarding certain physical commercial agreements, contracts or transactions.

¹ *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48208 (Aug. 13, 2012) (Final Rule).

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A. CFTC Interpretation Regarding Forward Contracts with Embedded Volumetric Optionality

In the Final Rule, the CFTC proposed a seven-part test to determine whether a forward contract with embedded volumetric optionality is eligible for the forward contract exclusion from the swap definition notwithstanding the embedded volumetric optionality.² The seventh part of the test requires the exercise or non-exercise of the embedded volumetric optionality to be “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.”³

EMUS encourages the CFTC to eliminate the seventh part of the test. At the core of the forward contract exclusion is the parties’ intent to deliver the underlying nonfinancial commodity. Unlike the other parts of the test, the seventh part focuses not on the parties’ intent to make and take physical delivery, but on whether or not the exercise or non-exercise of the embedded volumetric optionality is based on factors outside the control of the parties. The CFTC has not justified its proposal to expand the scope of the test beyond the parties’ intent to physically settle.

The seventh part of the CFTC’s proposed test is also impracticable. A market participant will need to apply the seven-part test to determine whether or not a forward contract with embedded volumetric optionality falls within the swap definition when it enters into the transaction. However, at the time it enters into the transaction, it may be impossible for the market participant to determine whether its counterparty’s future exercise or non-exercise of the embedded volumetric optionality will be primarily due to factors that are outside their control. The CFTC’s requirement that exercise or non-exercise of the embedded volumetric optionality be outside the parties’ control may also defeat the purpose of having embedded volumetric optionality in a forward contract which is to provide the option holder with the flexibility needed to prudently respond to changing external circumstances.

In the Final Rule, the CFTC posed seven questions regarding its interpretation concerning forward contracts with embedded volumetric optionality for public comment.⁴ EMUS’ responses to the questions posed by the CFTC are provided below:

1. *Are the elements set forth in the interpretation to distinguish forwards with embedded volumetric optionality from commodity options appropriate? Why or why not?*

EMUS Comment: The first six parts of the proposed test are appropriate since they merely restate the essential commercial terms of the forward contract where the parties intend to make or take deliveries under the forward contract. However, as explained in ConocoPhillips’ August 23, 2012 comments in this rulemaking, the seventh part of the test is problematic. There may be circumstances within the control of the party that, based on external factors not within the control of the party, cause the party to review its natural gas alternatives and, using its internal business judgment, select the best alternative for its natural gas by either taking or delivering more or less natural gas under a forward contract. For example, a hurricane in the Gulf of Mexico may not directly impact the New York area, but it will cause market impacts in New York. Sellers or buyers may select to take more or less natural gas under a

² *Id.* at 48238.

³ *Id.* (citations omitted).

⁴ *Id.* at 48241-42.

forward contract, or they may select an alternate market or supply for natural gas that could have been delivered but for the hurricane.

2. *Are there additional elements that would be appropriate? Please describe and provide support for why such elements would serve to distinguish forwards with embedded volumetric optionality from commodity options.*

EMUS Comment: EMUS believes that the first six parts of the test are sufficient for the CFTC to determine whether a forward contract with embedded volumetric optionality is eligible for the forward contract exclusion.

3. *Is the seventh element that, to ensure that an agreement, contract, or transaction with embedded volumetric optionality is a forward and not an option, the 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, necessary and appropriate? Why or why not? Is the statement of this element sufficiently clear and unambiguous? If not, what adjustments would be appropriate?*

EMUS Comment: As discussed above, the seventh part of the test is unnecessary and impracticable.

4. *Are there circumstances where volumetric optionality is based on other factors? Please describe. Would such factors, if made a part of the interpretation, serve to distinguish forwards with embedded volumetric optionality from commodity options? If so, how?*

EMUS Comment: No comment.

5. *Does the interpretation provide sufficient guidance as to whether agreements, contracts, or transactions with embedded volumetric optionality permitting a nominal amount, or no amount, of a nonfinancial commodity to be delivered are forwards or options, viewing the agreements, contracts, or transactions as a whole, if they satisfy the seven elements of the interpretation? Why or why not? Does this interpretation encourage evasion, or do the seven elements sufficiently distinguish forwards from agreements, contracts, and transactions that may evade commodity options regulation?*

EMUS Comment: EMUS believes that the first six parts of the test are sufficient to determine whether a forward contract with embedded volumetric optionality is eligible for the forward contract exclusion.

6. *Is the interpretation sufficiently clear with respect to capacity contracts, transmission (or transportation) services agreements, peaking supply contracts, or tolling agreements? Why or why not? Do capacity contracts, transmission (or transportation) services agreements, peaking supply contracts, or tolling agreements generally have features that satisfy the forwards with volumetric options interpretation included in this release? If so, which ones? If not, why not? Could these types of agreements, contracts, and transactions qualify for the forward exclusions under other parts of the interpretation set forth above? Are there material differences in the structure, operation, or economic effect of these types of agreements, contracts, and transactions as compared to full requirements*

contracts that are relevant to whether such agreements, contracts, and transactions are options under the CEA? Please explain. If so, what are the material differences?

EMUS Comment: No comment.

7. Do the agreements, contracts, and transactions listed in question No. 6 above have embedded optionality in the first instance? Based on descriptions by commenters, it appears that they may have a binding obligation for delivery, but have no set amount specified for delivery. Instead, delivery (including the possibility of nominal or zero delivery) is determined by the terms and conditions contained within the agreement, contract, or transaction (including, for example, the satisfaction of a condition precedent to delivery, such as a commodity price or temperature reaching a level specified in the agreement, contract, or transaction). That is, the variation in delivery is not driven by the exercise of embedded optionality by the parties. Do the agreements, contracts, and transactions listed in question No. 6 exhibit these kinds of characteristics? If so, should the CFTC consider them in some manner other than its forward interpretation? Why or why not?

EMUS Comment: No comment.

B. CFTC Interpretation Regarding Certain Physical Commercial Agreements, Contracts or Transactions

In the Final Rule, the CFTC provided an interpretation in response to comments regarding certain physical commercial agreements for the supply and consumption of energy that provide flexibility, such as tolls on power plants, transportation agreements on natural gas pipelines, and natural gas storage agreements.⁵ The CFTC stated that it will not interpret such an agreement, contract or transaction to be a commodity option if three elements are met.⁶ However, the CFTC then stated:

...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.⁷

An agreement for the use of a specified facility which contains a separate demand or reservation charge and usage charge is the standard rate structure for transportation and storage services in the

⁵ *Id.* at 48242.

⁶ Specifically, the CFTC will interpret an agreement, contract or transaction not to be an option if the following three elements are satisfied: (1) the subject of the agreement, contract or transaction 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, contract or transaction 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. *Id.*

⁷ *Id.*

energy industry. EMUS is concerned that the CFTC's interpretation means that many of the agreements commonly used in the energy industry, including firm natural gas transportation and storage agreements subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC) or state regulatory agencies, would be commodity options subject to the swap definition.

EMUS strongly encourages the CFTC to reconsider and retract its interpretation. The CFTC's requirement that there be a single charge – not a two-part rate structure – in order for certain agreements, contracts or transactions not to qualify as commodity options is inconsistent with the rate design methodologies used by FERC and state regulatory agencies. For example, in 1992, FERC issued Order No. 636⁸ which, among other things, established "straight-fixed variable" (SFV) cost classification, allocation and rate design as the default methodology for setting the rates of interstate natural gas pipelines. FERC's SFV methodology requires a two-part rate for jurisdictional natural gas transportation and/or storage services. All of a pipeline's fixed costs are allocated to the demand or reservation charge and all of its variable costs are allocated to the commodity charge. A firm shipper pays its share of fixed costs in a monthly demand or reservation charge which does not vary based on the amount of natural gas transported during the month. A firm shipper also pays a usage charge for its share of the pipeline's variable costs (e.g., operations and maintenance expenses directly related to volumes transported) which is based on the volume of natural gas transported during the month. The usage charge is designed to recover the pipeline's variable costs; it is not a payment for the exercise of a commodity option.

The physical commercial agreements, contracts or transactions at issue in the CFTC's interpretation, such as natural gas transportation and storage agreements that are already subject to FERC's jurisdiction, have never been considered to be swaps. There is no evidence that Congress intended for natural gas transportation and storage agreements to be regulated as swaps under the Dodd-Frank Act. The CFTC's interpretation appears to be inconsistent with Congress' directive in Section 720(a)(1) of the Dodd-Frank Act that the CFTC and FERC negotiate a memorandum of understanding to, among other things, establish procedures for "applying their respective authorities in a manner so as to ensure effective and efficient regulation in the public interest" and "avoiding, to the extent possible, conflicting or duplicative regulation." The CFTC interpretation is also inconsistent with the steps taken by Congress to minimize the impact of the Dodd-Frank Act on the non-financial end-users that commonly enter into the types of physical commercial agreements, contracts and transactions at issue. For example, Congress provided non-financial end-users an exemption from the mandatory clearing requirements in Section 2(h)(7)(A) of the Commodity Exchange Act (CEA).

If the CFTC intended to drastically expand the scope of its jurisdiction under the CEA to include physical commercial agreements, contracts or transactions that traditionally have not been considered to be swaps, especially natural gas transportation and storage agreements entered into pursuant to FERC-jurisdictional tariffs, it should have provided the public with notice and the opportunity to comment prior to issuing the interpretation in the Final Rule. However, it failed to do so prior to issuing the interpretation.

⁸ *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations*, 57 Fed. Reg. 13267 (Apr. 16, 1992) (Order No. 636).

If the CFTC does not reconsider and retract the interpretation as requested above, the CFTC should, on its own initiative, propose to exempt natural gas transportation and storage agreements that are entered into pursuant to a FERC-regulated tariff and similar agreements subject to the jurisdiction of state regulatory agencies from the requirements of the CEA and the CFTC's regulations.

III. Conclusion

EMUS appreciates the opportunity to file these comments on two of the CFTC's interpretations in the Final Rule. For the reasons set forth above, EMUS urges the CFTC to: (1) eliminate the seventh part of the test that it proposed to use to determine whether a forward contract with embedded volumetric optionality is eligible for the forward contract exclusion from the swap definition; and (2) reconsider or retract its interpretation regarding whether certain physical commercial agreements, contracts or transactions are swaps, or, in the alternative, propose to exempt such agreements, contracts or transactions from the requirements of the CEA and the CFTC's regulations.

Sincerely,

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