FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D. C. 20426

OFFICE OF THE GENERAL COUNSEL

October 12, 2012

VIA ELECTRONIC SUBMISSION

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

Re: 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 Staff of the Federal Energy Regulatory Commission

Dear Ms. Yochum:

On July 10, 2012, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission jointly promulgated final rules and interpretations (Product Definitions Rule)[1] pursuant to various provisions of the Commodity Exchange Act (CEA)[2] and the Securities Exchange Act of 1934,[3] as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),[4] to further define the term "swap" and certain other terms. The CFTC also invited further comment on its interpretation regarding forwards that contain embedded options, in particular, forwards with embedded volumetric optionality. The Staff of the Federal Energy Regulatory Commission (FERC) hereby submits these comments on the CFTC's interpretation regarding forwards with embedded volumetric optionality and facility usage agreements as related to transactions involving electricity and natural gas that are subject to FERC's jurisdiction.

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[1] 77 Fed. Reg. 48,208 (August 13, 2012).

[2] 7 U.S.C. §§ 1 et seq. (2006).

[3] 15 U.S.C. §§ 78a et seq. (2006).

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

FERC regulates the transmission and sale for resale of electricity in interstate commerce pursuant to the Federal Power Act (FPA),[5] as well as the transportation and sale for resale of natural gas in interstate commerce pursuant to the Natural Gas Act.[6] Generally, FERC has a statutory mandate to ensure that all rates charged for these sales or services are just, reasonable, and not unduly discriminatory or preferential. This responsibility extends to contracts or other arrangements and practices that significantly affect those sales and services. In this regard, section 722(e) of Dodd-Frank declares that nothing in Dodd-Frank "shall limit or affect any statutory authority of the Federal Energy Regulatory Commission . . . with respect to an agreement, contract, or transaction that is entered into pursuant to a tariff or rate schedule approved by the Federal Energy Regulatory Commission . . . and is (I) not executed, traded, or cleared on a registered entity or trading facility; or (II) executed, traded, or cleared on a registered entity or trading facility owned or operated by a regional transmission organization or independent system operator."[7]

Dodd-Frank excludes from the definition of "swap" "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."[8] In the Product Definitions Rule, the CFTC has provided helpful guidance on the applicability of the exclusion from the definition of the term "swap" under CEA section 1a(47)(B)(ii) with respect to nonfinancial commodities, including electricity and natural gas. The CFTC explained that it intends to interpret the forward contract exclusion for swaps consistently with its historic interpretation excluding forward contracts

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[5] 16 U.S.C. §§ 824 et seq. (2006).

[6] 15 U.S.C. §§ 771 et. seq. (2006). FERC also regulates interstate transportation services provided by intrastate pipelines pursuant to the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C §§ 3301 et seq. (2006). The NGPA generally requires that FERC ensure that the rates for such services be fair and equitable and not in excess of the rates interstate pipelines charge for similar services. "Transportation" as used in the NGA and the NGPA also encompasses natural gas storage.

[7] Dodd-Frank § 722(e) (adding new § 2(a)(1)(I)(i) to the CEA).

[8] *Id.* § 721(a)(21) (adding new CEA § 1a(47)(B)(ii)).

from regulation as futures contracts. The CFTC further limited the definition of "nonfinancial commodity" to commodities that can be physically delivered and that are exempt commodities (such as gas and electricity) or agricultural commodities. It clarified that environmental commodities (such as offsets, allowances, and renewable energy credits) are "nonfinancial commodities" for this purpose.

In response to comments received from FERC staff and other energy industry participants, the CFTC provided further guidance on its interpretation regarding forwards that contain "embedded" options, more specifically, forwards that have embedded volumetric optionality. The CFTC announced in the Product Definitions Rule that it would analyze forwards with volumetric optionality under a seven-part test to determine if they fall within the forward contract exclusion or, instead, should be regulated as swaps.[9] As discussed below, we are concerned that application of the seventh element of that seven-part test to many conventional electricity and natural gas forward contracts may cause significant uncertainty as to their status as excluded forwards.

The CFTC also provided guidance on the status of certain physical commercial agreements for the supply and consumption of energy, such as tolling agreements on power plants, transportation agreements on natural gas pipelines and natural gas storage agreements. The CFTC announced that such agreements, though having option-like features, would not be considered options (and hence not swaps) 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. Again, as discussed below, certain language in the CFTC's interpretation, specifically, its characterization of demand charges or reservation fees, which are very common features of certain FERC-jurisdictional contracts, is likely to lead to uncertainty as to the status of these agreements as swaps.

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[9] 77 Fed. Reg. at 48,238.

Our comments focus on these two aspects of the Product Definitions Rule.

1. The Seventh Element of Volumetric Optionality Test

In its request for further comment on its interpretation regarding forwards with volumetric optionality, the CFTC specifically asks whether the seventh element in the seven-part test is necessary and appropriate.[10] Under that element of the test, a contract or transaction would fall within the forward exclusion, notwithstanding that it contains embedded volumetric optionality, if "[t]he exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors,[*] or regulatory requirements,[*] that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity.[*]"[11]

FERC staff is concerned that this element of the test may be ambiguous or overly broad for two reasons. First, this element of the test seems to contemplate that the exercise or non-exercise of the embedded optionality on the part of the holder will be driven by external factors (e.g., demand). In fact, in the case of many energy transactions, the purchaser (i.e., the option holder), when faced with a need for additional supply as a result of external factors (e.g., a spike in demand), may have a variety of choices. A simple illustration in the electric industry is an agreement under which the buyer has contracted for the capacity of a generator with the right to call on the electrical output if and when needed. However, if such need arises, the buyer may have other, less expensive, ways to meet increased demand, for example, by purchasing power in the spot market. In this example, even if the parties entered into the arrangement with an intent of physical delivery, the seventh element of the test could be interpreted as reaching a contrary result. Moreover, if a buyer is regulated on a cost-of-service basis and chooses the least-cost approach under the circumstances, it is unclear whether its action would be considered as based on a "regulatory requirement." Thus, there may be some question as to whether the exercise or non-exercise of the embedded volumetric optionality is driven primarily or predominantly by external factors.

Secondly, and for reasons that are related to the first point we make above, whether or not the exercise or non-exercise of the embedded volumetric

[10] *Id.* at 48,241.

[11] *Id.* at 48,238 (footnotes omitted).

optionality is based "primarily" on physical factors outside the control of the parties would not be known at the time the contract is entered into. In fact, the seller under such a contract may have no way of knowing, at the time the contract is entered into, what factors would influence the buyer's decision to exercise or not exercise volumetric optionality.

Thus, the effect of the seventh element of the test, without further clarification or interpretation, may be to subject transactions that would otherwise fall within the forward contract exclusion under the first six elements of the test to the definition of "swap." Thus, we urge the CFTC, if it retains this element at all, to provide further clarification or interpretation so as to eliminate this uncertainty and an overly narrow interpretation of the forward contract exclusion.

2. Facility Usage Agreements

Natural gas firm transportation and storage contracts under FERC regulations typically provide for both a reservation fee and a usage fee. These contracts also typically involve a regulatory requirement that the pipeline sell that capacity as interruptible service in the event that a firm capacity holder does not use that capacity. However, for several reasons, we do not believe that these two components of this bifurcated fee structure run afoul of the distinctions that the CFTC makes between a payment for the use of a facility (not an option) rather than the option to use the facility that contemplates additional, future payments upon exercise.

Since FERC required interstate pipelines to restructure their services in Order No. 636, issued in 1992, interstate pipelines have only provided unbundled transportation and storage services.[12] They are not engaged in the business of buying and selling the natural gas commodity. Rather, they transport or store natural gas owned by others.

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

FERC requires that the maximum tariff rates for each service provided by a pipeline be designed to recover the pipeline's cost of providing that service.[13] Shippers (i.e., pipeline customers) frequently need to reserve sufficient pipeline transportation and/or storage capacity to serve their peak gas needs on a cold day. Interstate pipeline tariffs almost invariably include a two-part rate for their firm services, including a "reservation charge" imposed on each unit of the shipper's contractual entitlement to service and a "usage charge" imposed on each unit of service actually provided to the shipper pursuant to its scheduling requests.[14] FERC requires that a pipeline's reservation charge "must recover all fixed costs attributable to the firm transportation service, unless [FERC] permits the pipeline to recover some of the fixed costs in the volumetric portion of the two-part rate."[15] A pipeline's fixed costs are those costs that do not vary with the volume of gas it actually transports or stores on a particular day. FERC considers most of a pipeline's costs to be fixed, including its return on its equity investment, a depreciation allowance to recover that investment, and most of the pipeline's operation and maintenance costs. Thus, the reservation charge component may be analogized to a lease payment for a facility, which is designed to fully compensate the lessor for all of its fixed costs. A pipeline's variable costs include primarily the fuel used to run the pipeline compressors.[16]

Also, as noted above, FERC regulations provide that the use of the reserved pipeline transportation or storage capacity is not exclusive to the customer if the shipper does not need capacity on a particular day. For example, in the summer, a

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[13] 18 C.F.R. § 284.10(b)(4) (2012). FERC has permitted pipelines to charge market-based rates for some storage services, where FERC has found the pipeline lacked market power.

[14] FERC permits pipelines to negotiate rates with individual shippers which vary from the tariff rate, but each such negotiated rate must be filed for FERC approval.

[15] 18 C.F.R. § 284.7(e) (2012). FERC has rarely permitted the inclusion of any fixed costs in a pipeline's usage charge.

[16] Some intrastate pipelines performing interstate transportation service pursuant to the NGPA also have firm contracts with two-part rates similar to those of the interstate pipelines.

customer in the Northeast may not need to use its full reserved capacity. In this case, the pipeline can sell the capacity to other users on an interruptible basis, but only to the extent the firm shipper is not using its capacity. Moreover, in order to improve transparency, FERC has required pipelines to permit shippers that do not require their capacity on certain days to resell (release) that capacity to other customers who may need the capacity. However, as in a sublease situation, the releasing shipper remains liable to the pipeline for the full amount of its reservation charges to the extent that the replacement shipper fails to pay. These releases are often accompanied by a right to recall the capacity in the event the releasing shipper needs the capacity. FERC requires that these transactions are publicly posted.[17]

Also, we note that FERC does not permit pipelines to sell options for either the purchase or sale of capacity on their systems.[18] Thus, a shipper may not purchase an "option" to contract for firm service on a pipeline in the future. Rather, in order to purchase firm service on a pipeline, the shipper must enter into an actual contract for that firm service and pay for that service.

FERC staff requests that the CFTC clarify that, in these regulatory situations, such contracts are not options despite the fact that they are not exclusive and contain a variable component. A shipper's payment of a reservation charge which is designed to recover all or a substantial portion of the pipeline's fixed costs of providing service for the entire term of the contract should not be treated as a payment for simply an option to use the facility at some future date. FERC staff also believes that FERC's regulatory requirements concerning capacity release and pipelines selling capacity not used by firm shippers on an interruptible basis should not affect the analysis of whether the firm shipper's contract should be treated as an option.

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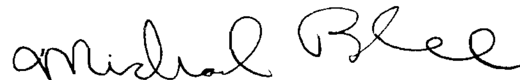
[17] If such transactions are considered options, customers may resort to a less transparent method of making that capacity available, such as by making a bundled gas sale that does not need to be posted.

[18] *Transwestern Pipeline Co.*, 95 FERC ¶ 61,165 (2001) (rejecting a pipeline's proposed options service).

FERC staff appreciates the opportunity to provide comments on aspects of the Product Definitions Rule.

Sincerely,



Michael Bardee
General Counsel
Phone: (202) 502-6000
Email: michael.bardee@ferc.gov

Cc: Jon Wellinghoff, Chairman
Philip D. Moeller, Commissioner
John R. Norris, Commissioner
Cheryl A. LaFleur, Commissioner
Tony T. Clark, Commissioner