



October 12, 2012

**Via Electronic Submission**

Stacy Yochum, Secretary  
Commodity Futures Trading Commission  
Three Lafayette Center  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

**Re: EEI and EPSA Comments on Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping (RIN 3235–AK65)**

Dear Ms. Yochum:

**I. Introduction**

The Edison Electric Institute (“EEI”) and the Electric Power Supply Association (“EPSA”) respectfully submit these comments in response to the Commodity Futures Trading Commission’s (the “Commission”) Joint final rule; interpretations; request for comment on an interpretation on Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping (“Final Rule”).<sup>1</sup> EEI and EPSA offer these limited comments<sup>2</sup> on the proposed seven-factor test enumerated in the Final Rule for embedded volumetric options and on the Commission’s

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<sup>1</sup> *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”).

<sup>2</sup>EEI and EPSA also specifically support the concerns expressed in the NFP Electric Associations letter filed in this docket on September 12, 2012 addressing the interpretation requiring parties to a nonfinancial commodity transaction to document oral bookouts. This requirement can be burdensome and should be withdrawn. EEI and EPSA agree with the NFP Electric Associations that the Commission vastly underestimates the number of bookouts that occur each year as well as the burden placed on EEI and EPSA members, especially smaller members, with this new requirement. Some EEI and EPSA members have engaged in bookouts of forward power contracts for decades over the telephone, but the new regulatory requirement will require the installation of new systems, new procedures and potentially the hiring of new personnel. As such, EEI and EPSA agree with the NFP Electric Associations that this documentation requirement for excluded commodities can be burdensome and should be withdrawn.

proposed interpretation concerning certain physical commercial agreements, contracts or transactions.

Specifically, as discussed in detail below, EEI and EPSA request that:

- Contracts with embedded volumetric optionality should be subject to the same three-factor test as contracts with embedded optionality, related to price or other terms, as the predominant feature of both of these contracts is actual delivery;
- In the alternative, contracts with embedded volumetric optionality should be considered excluded nonfinancial commodity forward contracts (and not swaps) if they meet the first three elements of the proposed seven-factor test for contracts with embedded volumetric options. The remaining four elements of the seven-factor test, and at a minimum, the seventh factor of the proposed seven-factor test should be eliminated;
- The Commission should withdraw its proposed interpretation regarding certain physical commercial agreements contracts or transactions, such as tolling agreements, natural gas transportation and storage agreements, and firm transmission agreements. These contracts provide essential services to facilitate the physical delivery of commodities, which is the most basic element of transactions that Congress intended to be exempt from the regulatory framework established by the Dodd-Frank Act for swaps.

EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 95 percent of the ultimate customers in the shareholder-owned segment of the U.S. electricity industry, and represent approximately 70 percent of the U.S. electric power industry. EEI also has more than 65 international electric companies as Affiliate members, and more than 170 industry suppliers and related organizations as Associate members.

EPSA is the national trade association representing competitive power suppliers, including generators and marketers. These suppliers, who account for nearly 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities. EPSA seeks to bring the benefits of competition to all power customers.

EEI and EPSA's members are physical commodity market participants that rely on swaps and futures contracts primarily to hedge and mitigate their commercial risk. They are not financial entities. As users of contracts with embedded options and other commercial agreements, such as storage and transportation contracts, to facilitate physical delivery of commodities, EEI and EPSA's members have a significant interest in the Commission's Final Rule and the enumerated tests used to determine if contracts with embedded options will be considered as forward contracts and not as swaps.

## II. Comments

- A. Contracts with embedded volumetric optionality should be considered excluded nonfinancial commodity forward contracts (and not swaps) if they meet the three-factor test for embedded options or in the alternative the first three elements in the proposed seven-factor test**
- 1. The Commission's initial three-factor test is appropriate and could be used for all contracts with embedded options, including contracts with embedded volumetric optionality**

In the Final Rule, the Commission determined that forward contracts should be excluded from the definition of the term "Swap"<sup>3</sup> largely by incorporating its existing analysis of forward contracts.<sup>4</sup> In doing so, the Commission fashioned a three-factor test to determine if certain forward contracts with embedded options will continue to be treated as forward contracts and not swaps. In accordance with an initial three-part test, "[a] forward contract that contains an embedded commodity option or options will be considered an excluded nonfinancial commodity forward contract (and not a swap) if the embedded option(s):

- (1) may be used to adjust the forward contract price but do not undermine the overall nature of the contract as a forward contract;
- (2) do not target the delivery term, so that the predominant feature of the contract is actual delivery; and
- (3) cannot be severed and marketed separately from the overall forward contract in which they are embedded."<sup>5</sup>

EEI and EPSA agree with the Commission that transactions that meet the requirements of this initial three-factor test should be considered excluded nonfinancial commodity forward contracts and not swaps. The predominant feature of these contracts, as contemplated by the parties at the time the contract was entered into, is actual delivery; the embedded optionality does not undermine the overall nature of these contracts as forward contracts. As such, EEI and EPSA agree that these contracts with embedded options should be considered excluded nonfinancial forward contracts and not swaps.

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<sup>3</sup> The Commission indicates that it is interpreting the term swap to include a guarantee of such swap and that it will be issuing a separate release to address the practical implications of this interpretation. 77 Fed. Reg at 48226. EEI and EPSA request that the Commission issue a Notice of Proposed Rulemaking to solicit input on this interpretation as the types of guarantees available in the electric industry (financial guarantees, asset liens, etc.) vary widely. As such, the guarantee of swaps should not automatically be considered swaps and should be separately evaluated under the tests put forth by the Commission.

<sup>4</sup> *Id.* at 48227– 48230.

<sup>5</sup> *Id.* at 48237.

The Commission should adopt a single three-factor test for contracts with all types of embedded optionality rather than creating a separate seven-factor test for contracts with volumetric optionality as discussed below. EEI and EPSA assert that the proper interpretation of the second factor in the three-factor test, outlined above, is that volumetric optionality (i.e. targeting the delivery term) should not cause a contract to fail unless the volumetric optionality changes the overall nature of the contract such that the predominant feature of the contract is no longer physical delivery.<sup>6</sup> Just like a commercial party can defer delivery until a future date, it likewise can defer selecting the exact quantity that it desires to be delivered until a future date. Indeed, the two often go hand in hand. For example, a utility that serves end-use customers will frequently enter into a forward contract to purchase an amount of energy that can be taken seasonally and that varies in volume seasonally. Thus, the utility may have the right to purchase up to 20 MW of power in the summer months and up to 10 MW in the winter months, provided it cannot ever purchase less than 5 MW. This temporal optionality does not undermine the overall nature of the contract as a forward contract and the predominant feature of the contract is actual delivery of power.

Using this three-factor test for all forward contracts with embedded optionality, including those with volumetric optionality, preserves the Commission's goal in assuring that contracts that are physical delivery forwards are properly excluded from the definition of swap in a clear and targeted manner. For example, if the embedded option provides a mechanism for financial settlement in lieu of physical delivery, then the predominant feature of the contract is not actual delivery<sup>7</sup> or if the option is free standing or can be separately marketed<sup>8</sup>, then it will not be considered an excluded nonfinancial commodity forward contract. Thus, the Commission should reconsider its interpretation that a separate test is needed for contracts with embedded volumetric options and simply rely on the three-factor test for contracts with embedded options for all types of embedded options including volumetric.

## **2. The seven-factor test applicable to forward contracts with embedded volumetric optionality should be revised**

If the Commission chooses not to rely solely on the initial three factor test for embedded options for guidance on contracts with embedded volumetric optionality, then EEI and EPSA suggest that the Commission modify the seven-factor test for contracts with embedded volumetric optionality. EEI and EPSA believe that the Commission intended for this seven-factor test to determine whether such volumetric optionality undermines the overall nature of the

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<sup>6</sup> In describing the second factor of the three-factor test for embedded options, the Commission stated: "When the Proposing Release stated that the forward contract containing an embedded option that does not "target the delivery term is an excluded forward contract, it meant that the embedded option does not affect the delivery amount." *Id.* at 48240.

<sup>7</sup> *In Re Wright*, CFTC Docket No. 97-02, 2010 WL4388247 at 12 (CFTC Oct. 25, 2010).

<sup>8</sup> *Id.* at 13.

contract as a forward contract. In accordance with the seven-part test, 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:

- (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 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 delivery of the underlying nonfinancial commodity if it exercises the embedded volumetric optionality;
- (6) both parties are commercial parties;
- (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.<sup>9</sup>

EEI and EPSA propose that contracts with embedded volumetric optionality that meet the first three elements of the seven-factor test should be treated as excluded nonfinancial commodity forward contracts and not swaps. Factors 4-6 appear to serve no purpose and are redundant to the threshold question of whether the optionality undermines the overall nature of the contract as a forward contract. As explained by the Commission, a forward contract is a “commercial merchandising transaction which creates an enforceable obligation to deliver.”<sup>10</sup> Thus, a review of factors 4-6 shows that they restate a question *that must have been answered in the affirmative before one arrives at an optionality analysis*. This redundancy serves no analytical purpose in the optionality analysis and can only cause confusion. Furthermore, as ConocoPhillips points out, Parts 4 and 5 of the seven-factor test contain language appropriate

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<sup>9</sup> 77 Fed. Reg. at 48238.

<sup>10</sup> *Id.* at 48228.

only to embedded optionality in the form of call options and do not conform appropriately to embedded optionality in the form of put options.<sup>11</sup>

The seventh factor of the seven-factor test articulates a new test that is not required by the statutory language that excludes from the definition of a 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.”<sup>12</sup> The seventh factor requires that the exercise or non-exercise of an option must be based primarily on physical factors or regulatory requirements that are outside of the control of the parties.<sup>13</sup> 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.<sup>14</sup> As indicated by ConocoPhillips, in some cases” embedded volumetric optionality is created for the purpose of providing the option holder with flexibility to respond to changing circumstances.<sup>15</sup> EEI and EPSA members create a physical supply portfolio designed so that they can provide electric service at just and reasonable rates for their retail customers. In some cases, this may entail making economic decisions to reduce the volumes based on factors other than weather or regulatory requirements. As such, the exercise of volumetric optionality can be based on a number of factors and it is not always clear what is beyond the control of the parties as required by the rule.

Further, the determination of whether or not a particular contract is an excluded forward contract must be made at the time the contract is entered into. At that time, as seen from the foregoing, the parties to a contract cannot possibly know the precise reasons volume optionality may be called upon at some future point. The outcome of a test that can only be applied retroactively will be confusion among the parties as to how to apply the test when they must do so prospectively. Because neither party to a contract can know with certainty that an exercise on some future date will be based upon factors outside of their control, at the time of entering into the transaction, the seventh factor is commercially unworkable and could have negative implications for the marketplace such that market participants will be reluctant to offer anything other than fixed quantity or full requirement contracts. Finally, unlike the first three parts of the seven-factor test, the seventh factor does not concern itself with the question of whether the forward contract has been so impacted by its embedded optionality such that it should be considered a commodity option and not an excluded nonfinancial commodity forward contracts.

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<sup>11</sup> Public Comments on the Commission’s Interpretation Regarding Forwards with Embedded Volumetric Options at 4-5 (Aug. 23, 2012) (“ConocoPhillips Letter”)

<sup>12</sup> CEA section 1a(47)(B) (ii)

<sup>13</sup> 77 Fed. Reg at 48238.

<sup>14</sup> *Id.* at 48238 n. 341.

<sup>15</sup> ConocoPhillips Letter at 3.

*Given the analytical problems caused by the seventh factor, the Commission, at a minimum, should eliminate it altogether regardless of any other action it takes concerning the tests for embedded options articulated in the Final Rule.*

**B. The Commission should withdraw its interpretation regarding certain physical commercial agreements, contracts or transactions.**

In addition to the concerns about the seven-factor test as discussed above, EEI and EPSA have concerns regarding the Commission's interpretation of certain physical commercial agreements, contracts or transactions. Through this interpretation, which appears for the first time in the Final Rule, the Commission addresses the regulatory treatment of contracts such as tolling agreements, natural gas transportation and storage agreements and possibly firm transmission agreements. With regard to these types of transactions, the Commission created a three-factor test to provide guidance on conditions the transaction must meet in order for these transactions not to be classified as an option.<sup>16</sup> The Commission also states that if the right to use the facility is only obtained 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.<sup>17</sup> EEI and EPSA assert that this interpretation creates regulatory uncertainty and should be withdrawn in its entirety as it impacts innumerable transactions that are commonly used in the electric industry for the delivery of nonfinancial commodities, which were never envisioned to be so included by Congress in its enactment of the Dodd-Frank Act.

This portion of the Final Rule appears to subject both highly regulated and commercial contracts for services to CFTC regulations which is beyond the intention of the authors of the Dodd-Frank swaps regulation. The legislative record underlying Dodd-Frank does not support a finding that Congress intended pipeline transportation, storage, firm transmission agreements or fuel conversion through tolling to be considered swaps. These tariffs and contracts should not be viewed as forward contracts or commodity options. They should be viewed as exactly what they are: infrastructure services used to facilitate actual delivery.

Congress clearly instructed the Commission and other regulators to “appl[y] their respective authorities in a manner so as to ensure effective and efficient regulation in the public interest” and avoid “to the extent possible, conflicting or duplicative regulation.”<sup>18</sup> The inclusion of these contracts within the definition of the term swap is a direct example of the type of regulatory duplication that Congress did not want to occur, as the Federal Energy Regulatory

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<sup>16</sup> 77 Fed. Reg. at 48242.

<sup>17</sup> *Id.*

<sup>18</sup> Dodd-Frank at § 720.

Commission (“FERC”) and the state regulatory commissions already provide appropriate regulatory oversight.

The three part test and the additional language proposed by the Commission suggests that every facility usage contract that has a demand charge or reservation fee and a fee to use the facility is an option subject to regulation by the Commission. As indicated in the ConocoPhillips letter, tolling agreements, and natural gas transportation and storage contracts among other are commonly structured with two-tiered pricing.<sup>19</sup> In particular, a two-tiered rate structure for natural gas and transportation contracts is mandated by FERC rules and regulations for interstate pipelines and by the state commissions for intra-state pipelines. In addition, the three-factor test also requires that the contract must apply to a specified facility. This requirement, if narrowly applied, is counter to general practice in the electric and natural gas industries. For example, interstate natural gas pipelines typically provide storage services to customers under terms and conditions of FERC approved tariffs that do not reference specific facilities. Pipeline transportation, storage, firm transmission agreements or fuel conversion through tolling contracts are not commodities themselves but, rather, are vehicles by which commodities can be transported or processed. The CFTC should treat them like other transportation or processing services and not subject them to CEA regulation.

Accordingly, EEI and EPSA respectfully request that the Commission clarify that natural gas transportation and storage agreements, electric and gas tolling agreements and electric transmission agreements are not commodity options or swaps subject to Commission jurisdiction or that they fall within the forward contracts exclusion.<sup>20</sup> As such, EEI and EPSA request that the Commission withdraw its interpretation in its entirety.

### **III. Conclusion**

For the afore mentioned reasons, EEI and EPSA respectfully request that the Commission: (1) either modify its interpretation of the three-factor test to recognize that volumetric optionality does not affect the actual delivery requirement or modify the seven factor test for contracts with embedded options with volumetric optionality and (2) withdraw its interpretation, in its entirety, regarding certain physical commercial agreements, contracts or transactions. Please contact the undersigned at the number listed below if you have any questions regarding these comments.

Respectfully submitted,

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<sup>19</sup> ConocoPhillips letter at 7.

<sup>20</sup> EEI and EPSA support the request for no-action relief for these transactions until such time as a final clarification, interpretation or response is issued. See e.g. Request for Clarification and No-Action Relief Regarding Commission Application of the Forward Contract Exclusion to Transportation and Storage Agreements in Physical Commodities filed by AGA, NGSA,, AGI, IPAA (September 12, 2012)





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