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Via Online Submission

Stacy Yochum
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; Final Rule, RIN No. 3038-AD46

Dear Ms. Yochum:

On August 13, 2012, the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") published in the Federal Register a joint final rule entitled "Further Definition of 'Swap,' 'Security-Based Swap' and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping" (the "Product Rule").[1]

In the Product Rule, the CFTC included a "Request for Comment" concerning its interpretation regarding forward contracts with volumetric options.[2] Under that interpretation, certain contracts that would otherwise qualify as forward contracts, and therefore are not swaps, but that contain certain optionality with respect to commodity volume must meet a series of criteria in order to be considered forwards and not swaps.[3] The Coalition of Physical Energy Companies ("COPE") hereby provides comments in response to the CFTC's request.[4] The members of COPE are physical energy companies in the business of producing, processing, and merchandizing energy commodities at retail and wholesale.

[1] 77 Fed. Reg. 48208 (August 13, 2012).

[2] Product Rule at 48241.

[3] *See Id.* at 48238.

[4] The members are: Apache Corporation; EP Energy LLC; Enterprise Products Partners, L.P.; Iberdrola Renewables, Inc.; Kinder Morgan; MarkWest Energy Partners, L.P.; Noble Energy, Inc.; NRG Energy, Inc.; Shell Energy North America (US), L.P.; SouthStar Energy Services LLC; and Targa Resources.

The CFTC's Approach to Volumetric Optionality Is Overly Complicated and Confusing and the Inclusion of Infrastructure Service Agreements Is Misplaced

As a threshold matter, COPE believes and has advocated that any contract, agreement, or transaction that, by its terms, can only be settled with physical delivery should not be included within the definition of a Swap.[5] The CFTC's request for comment on its interpretation of forwards with embedded volumetric optionality, along with Commissioner Wetjen's concern expressed at the CFTC meeting considering the Product Rule as to whether the agency "got it right," highlight the confusion and hairsplitting that result when physical delivery contracts are deemed to be included in the definition of Swap.[6]

Beyond the CFTC's blanket determination that physical commodity options are swaps,[7] the CFTC has also created confusing multi-pronged tests to be applied to commodity and service transactions to determine whether they are forward contracts or commodity options and, therefore, swaps. To answer Commissioner Wetjen's question, the CFTC did not get it right.

The tests in the Product Rule for facility-related service contracts and physical delivery contracts with embedded volumetric optionality are problematic for several reasons. Many of these contracts are structured in a manner that is required by other regulators such as the Federal Energy Regulatory Commission ("FERC") or a state regulatory body. It would be perverse to find that rate structures enacted by FERC or other regulators compelled CFTC jurisdiction, thus subjecting these transactions to potentially conflicting regulation. Further, COPE members routinely enter into physical delivery contracts to meet the physical commodity demands of their business. Such contracts are designed to meet the commercial needs of the contracting parties, and as such they do not normally contain specific, non-commercial triggering elements for volumetric optionality that are "outside of the control of the parties."[8] Instead, they are drafted such that each party has particular rights that may include a right to vary the volume of the physical commodity delivered in the course of the transaction. A contracting party with such a right will typically require a contract term that provides it with discretion in triggering the volumetric variance as a matter of commercial necessity. That decision may be based upon many factors, including those beyond its control; however, the contract will not typically specify that the factors upon which that party will base its decision are "outside of its control." That party may have a view at the outset as to what will cause it to exercise its rights with respect to volume variance, but it will not be limited to this view and will instead have the right under the

[5] *See* Comments of the Coalition of Physical Energy Companies re: Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping (Notice of Proposed Rulemaking), filed July 22, 2011; Comments of the Coalition of Physical Energy Companies re: Commodity Options (Interim Final Rule), filed June 26, 2012.

[6] COPE would be pleased if the CFTC were to reverse its holding on this issue but will not reargue its views in this filing.

[7] *See* Product Rule at 48236.

[8] *Id.* at 48238 ("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.") (emphasis added).

contract to vary the volume according to the contract's terms. The other party can only speculate as to why the optionality will or will not be exercised, as those reasons are beyond the commercial scope of a typical COPE member's physical commodity agreements.

As set forth with more specificity in the answers to the CFTC's questions below, COPE requests that the multi-part tests be simplified and better directed towards a determination of whether the contract can be meaningfully viewed as an <u>option</u>, rather than as a physical delivery forward contract. The default position should be that a transaction that is a forward contract will not be transformed into a swap unless it is significantly similar to an actual option contract - not merely because it contains some sort of optionality.

The analytical construct that the CFTC has created asks: (1) is the physical delivery contract a commodity option or forward contract with optionality; and (2) does the optionality cause the forward contract to be considered a commodity option? Therefore, the only real question is whether the optionality tips the scale in the direction of an option rather than a forward. Some of the CFTC's prongs are relevant to this determination while others are not. If they are not, they should be eliminated.

As of this date, COPE members have devoted resources and time to reviewing their contracts to determine whether they fall on the forward or commodity option side of the fence. Even after this exercise, there is significant ambiguity as to how certain contracts should be viewed, due to the fact that the CFTC's published guidance on what is required for a physical contract with volumetric optionality to remain a forward is ambiguous and fundamentally bears little relation to the commercial realities of the physical markets in which COPE members operate. Further, members have considered altering their contracts to make sure they fall on the forward side of the fence based on the CFTC's guidance thus far. To avoid unproductive contract reviews and commercial restructurings, COPE requests that the CFTC revise its guidance on forwards with embedded optionality to remove the ambiguity and align its interpretation with commercial reality.

Finally, COPE believes the CFTC should remove infrastructure service contracts from the category of contracts subject to this analysis and regulation under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[9] These contracts are certainly not the type of arrangements Congress intended to regulate as swaps. Regulation of these often highly regulated contracts by yet another regulator serves no public policy purpose and contravenes the legislative requirement to avoid duplicative regulation.[10] Whether or not these contracts are already highly regulated, they provide for a service that, in general, is used to bring a commodity to market. In this case they are no different from rail, barge, or truck transportation or the conversion of corn into cornflakes by a third party processing facility (a "corn tolling agreement"). COPE does not believe the CFTC intended to expand the scope of its regulation to all of these services if their contracts met a multi-part test. The CFTC should eliminate this class of contracts from Dodd-Frank oversight.

[9] Public Law No. 111-203, 124 Stat. 1376 (2010).

[10] *See* Dodd-Frank at § 720 (instructing the CFTC to avoid " to the extent possible, conflicting or duplicative regulation.").

Specific Responses to Requests for Comment

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

   Item Nos. 1-3 are appropriate. These items are related to the nature of the contract (option/forward).

   Item Nos. 4-6 are not appropriate. These items are related to intent to deliver and the parties' status as commercial parties. As such, they are redundant to the threshold determination that the contract in question is a forward contract and result in a confusing/unnecessary restatement of the analysis that has already been undertaken to designate the subject contract as a forward. As explained by the CFTC, a forward contract is a "commercial merchandising transaction[] which create[s an] enforceable obligation[] to deliver." [11]

   Item No. 7 is irrelevant to the question at issue - whether a contract is a forward or an option. It focuses on the reason why the optionality is exercised. Such a reason has absolutely nothing to do with whether a contract is an option. For example, there are many forward contracts for which delivery is required based on other than "physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity."[12] *The CFTC has not proposed to make such forward contracts into swaps. Likewise it has given no meaningful reason why this criteria is determinative of whether a forward contract is a commodity option. Finally, the criteria in Item No. 7 is inconsistent with commercial realities. Parties simply do not draft contracts with provisions that are triggered by forces "outside the control of the parties and are influencing demand." Rather, contracts set forth the rights and obligations of the parties. If a party has the right to require additional volumes, the other party needs proper notice of relevant information including volumetric requirements. It does not need to know (nor should it care) why the additional volumes are needed, and thus contracts do not generally spell out such information or require the parties to do so.*

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.

   No.

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,

[11] Product Rule at 48228.

[12] *Id*. at 48238 (internal citations omitted).

necessary and appropriate? Why or why not? Is the statement of this element sufficiently clear and unambiguous? If not, what adjustments would be appropriate?

See response to Question 1 above. This statement is not clear. It is very ambiguous. For example, COPE assumes that the contract must be categorized at execution as a forward or option. However, at that time, neither party will typically know for an absolute certainty what will drive exercise (the commodity world is dynamic and conditions change). The seller may never know why the buyer exercised.

Item No. 7 should be deleted.

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?

   It should not matter why the party has exercised its rights to call or put. The question should be whether the contract is fundamentally a forward or an option.

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?

   As stated above, Item No. 7 is redundant to the threshold question of whether the contract is a forward (albeit with optionality,), as well as ambiguous. The likely effect, if it is not altered, is that parties will avoid including volumetric optionality in their forward contracts. Such result will be inefficient and harmful to commodity markets.

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?

   No. This provision is significantly ambiguous and appears designed to subject highly regulated commercial contracts for services well beyond the imagination of the framers of Dodd-Frank to swaps regulation. COPE believes it can be said with confidence that the legislative record underlying Dodd-Frank does not support a finding that Congress intended pipeline transportation, storage, 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. If one was to pay a monthly reservation charge to drive though the Lincoln Tunnel with an additional discounted fee for each trip, would that be a commodity option? (The Product Rule implies the answer is yes.) Simply stated, this category of contract should be dropped from the rule.*

If the CFTC will not drop the category, it should revise its test. The test should be, as it is for any option: is the buyer purchasing the right to enter into a transition at set terms? The acquisition of the optionality should be viewed independently of the service. If a contract has an option premium for the procurement of a contract right to purchase a service and, upon exercise, the provision/purchase of the service, then it could conceivably be viewed as an option. Absent those facts, it should not be considered a swap.

7. Do the agreements, contracts, and transactions listed in questions 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?

   No. Variations are based upon commercial factors and market conditions. These contracts are means to an end, and they are not options. If I want to sell gas, I need to get it to the market. If I want to convert my gas into electricity, I need to "rent" a power plant to do so. As stated above, these transactions should not be considered either forward contracts or commodity options. They simply have no place in CFTC regulation.

Conclusion

For the foregoing reasons, COPE respectfully requests that the CFTC modify and/or provide interruptive guidance to more clearly and appropriately identify forward contracts with optionality that should be considered commodity options and remove infrastructure service contracts from the scope of the definition of swap.

Respectfully Submitted,

/s/ David M. Perlman

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