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October 12, 2012

Ms. Sauntia Warfield, Assistant Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

VIA ELECTRONIC MAIL

Re: *Comments in Support of ConocoPhillips' Public Comments on the Commission's Interpretation Regarding Forwards with Embedded Volumetric Options; RIN No. 3038-AD46*

Dear Ms. Warfield:

I. INTRODUCTION.

On behalf of The Commercial Energy Working Group (the "**Working Group**"), Sutherland Asbill & Brennan LLP hereby submits these comments in support of and to further expound upon the August 23, 2012 comment letter submitted by ConocoPhillips ("**COP**," and with respect to its comment letter, the "**COP Comments**") in response to the proposed interpretive guidance regarding the treatment of forwards with embedded volumetric optionality by the Commodity Futures Trading Commission (the "**CFTC**" or "**Commission**") in its final rule further defining the term "swap" (the "**Final Rule**").[1] The Working Group appreciates the opportunity to provide the comments set forth herein and respectfully requests the Commission's consideration of such comments.

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are energy producers, marketers, and utilities. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

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[1] *See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Recordkeeping*, 77 Fed. Reg. 48,208 (Aug. 13, 2012).

II. COMMENTS OF THE WORKING GROUP.

A. The Working Group Supports the COP Comments.

The Working Group believes that the COP Comments are an accurate and articulate depiction of the issues that arise from the Commission's proposed treatment of forward contracts with embedded volumetric optionality and certain usage contracts. The Final Rule may bring several types of commercial contracts within the definition of "swap" that Congress did not intend to be within the scope of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). This broad reading of "commodity option" will have burdensome and unnecessary consequences for the commercial energy and other industries.

The Working Group agrees with COP's assessment of the seven-part test the Commission has proposed for contracts with embedded volumetric optionality and believes that the proposed test should be amended to appropriately determine whether such volumetric optionality undermines the overall nature of the contract as a forward contract.[2] We urge the Commission to eliminate Part 7 of the seven-part test in the Final Rule. We also urge the Commission to adopt certain technical modifications to Parts 4 and 5 of the seven-part test. The Commission should focus its analysis of forward contracts with embedded volumetric optionality on (a) the commercial nature of the transaction and (b) the transacting parties' intent to physically settle the forward purchase and sale. With the modifications to Parts 4 and 5 discussed below, the first six parts of the seven-part test are sufficient to determine whether or not a given contract or transaction satisfies the Commission's requirement that an excluded nonfinancial commodity forward contract maintain its predominant feature of a "binding, albeit deferred, delivery obligation."[3]

In addition, contracts for transportation, storage or other uses or services should not be categorized as swaps or commodity options. Contracts that are used by manufacturers, producers, processors, commercial users and merchandizers in connection with their businesses, and which are intended to result in the physical delivery of a commodity, are not financial contracts and should not be regulated as such.

i. The Seven-Part Test – Part 7.

The Working Group concurs with COP's delineation of the problems that arise in the Commission's proposed seven-part test to evaluate a forward contract with embedded volumetric optionality. Part 7 of the seven-part test would require that the exercise or non-exercise of an embedded volumetric option be "…based primarily on physical factors… that are outside the control of the parties and are influencing demand for, or supply, of the nonfinancial commodity."[4] As stated in the COP Comments, this standard is unworkably vague. The Commission does not provide criteria that firms may use to identify adequate factors that are

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2 *See Id.* at 48,238.

3 *See Id.*

4 *Id.*

both (a) outside their control and (b) influence demand and supply. This standard also does not place full emphasis on best execution. Thus, it places a regulatory impediment on market participants' ability to exercise prudence in their decision-making and act in the best interest of their shareholders. In the case of certain regulated entities, the test, with its emphasis on exogenous drivers, interferes with companies' ability to act in the best interest of their customers.

Additionally, Part 7 of the seven-part test imposes a retroactive intent test as part of the definition of "swap" that is absent from the extensive definition of such term in the Dodd-Frank Act. As noted by COP, a party to a transaction cannot know the true intentions of its counterparties at the time of execution, nor can it predict what exogenous factors in the future will determine its counterparties exercise or non-exercise of an embedded volumetric option. Alternatively, potentially reclassifying a physical transaction as a swap upon the exercise of an embedded option will also give rise to numerous technological challenges. This inability to forecast prospective behaviors and to classify a transaction at the time of execution creates regulatory uncertainty that the Commission should remedy.

For these reasons, the Working Group supports the removal of Part 7 from the seven-part test.[5]

ii. The Seven-Part Test – Parts 4 and 5.

The Working Group also agrees with COP's assessment of Parts 4 and 5 of the seven-part test, which respectively require that "[t]he seller… intends… to deliver… if the optionality is exercised," and that "[t]he buyer… intends… to take delivery… if it exercises the embedded volumetric optionality."[6] As COP notes, these obligations are correct for call options, but not for put options. The Working Group respectfully requests that the Commission revise the wording in Parts 4 and 5 of the seven-part test to conform to the language set forth in the COP Comments.

iii. Usage Contracts.

The Final Rule provides an improper regulatory treatment for "usage contracts" (*i.e.*, agreements providing for the usage of facilities such as pipelines, storage facilities or power stations, and including tolling agreements[7]) by incorrectly expanding the scope of the definition

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5 Further, we note that the Commission's three-part test for evaluating whether a forward contract with an embedded option qualifies for the forward contract exclusion also needs further clarification or modification. The Commission should clarify that Part 2 of the three-part test allows for embedded options to target the delivery term <u>*so long as*</u> *the predominant feature of the contract is actual delivery*. As the two-clause Part 2 currently reads, it is unclear whether transactions will qualify for the forward contract exclusion if the embedded option targets *any* aspect of the delivery term, regardless of the extent to which this affects the nature of the transaction as a whole. *See Id*. at 48,237.

6 *See Id.*

7 Tolling agreements are transactions in which one party supplies an unprocessed or unrefined commodity to another party, which processes or refines the commodity, and in turn, the processed/refined commodity is marketed by the first party to customers. Essentially, a tolling agreement operates like a lease, as the initial party is paying for the use of another party's facilities in order to convert its commodity into a marketable product.

of "swap." The Commission should remove the applicable section of the Final Rule or, at a minimum, clarify its discussion so usage contracts are categorically not swaps.

Usage contracts should not be regulated as swaps or commodity options, as Congress never intended them to be treated as such in the Dodd-Frank Act. The Working Group confirms that the two-tier approach outlined by COP, in which a usage contract has both a demand charge and a variable cost, is the standard fee structure for a variety of commercial usage contracts utilized by Working Group members on a regular basis. In the case of natural gas transportation agreements, this payment structure is mandated by FERC.

The Commission has inappropriately focused on pricing structure as a distinguishing feature of contracts it considers to be commodity options. These contracts are more akin to the types of consumer and commercial contracts and transactions that the Commission interprets as falling outside the definition of "swap" elsewhere in the Final Rule. They 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 for swaps by the Dodd-Frank Act.

B. Further Comments of the Working Group With Regard to the Final Rule.

Beyond the observations and recommendations made in the COP Comments, the Working Group has additional comments regarding the CFTC's proposed interpretive guidance on the regulatory treatment of forward contracts with embedded volumetric options and usage contracts.

i. The Final Rule Will Make it Unnecessarily Difficult for Commercial Entities to Rely on the Bona Fide Hedge and the End-User Exemptions.

As the Final Rule is written, the regulatory treatment of usage contracts has implications beyond those discussed in the COP Comments. Commercial firms in the energy industry regularly transact in swaps in order to hedge the commercial risk that arises from their transportation and storage contracts. If these usage contracts are deemed to be commodity options, even if they qualify for the trade option exemption,[8] any hedges to mitigate the risk surrounding these usage contracts will now be considered as "swaps hedging other swaps." Whereas these transactions previously would have qualified for the *bona fide* hedge exemption under the CFTC's former position limits rule (the "**Position Limits Rule**"),[9] as well as the CFTC's end-user exemption from clearing (the "**End-User Exemption**"),[10] these exemptions may no longer apply because the Commission has provided that "swaps hedging other swaps"

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[8] *See Id.* at 25,338.

[9] *See Position Limits on Futures and Swaps*, 76 Fed. Reg. 71,626 (Nov. 18, 2011). Though this rule was recently vacated, we proffer these comments in case they are germane to any subsequent rulemakings on position limits.

[10] *See End-User Exception to the Clearing Requirement for Swaps*, 77 Fed. Reg. 42,560 (Jul. 19, 2012) (the "End-User Exemption").

are not *bona fide* hedging transactions and are not necessarily transactions hedging or mitigating commercial risk.[11]

The Commission states in the End-User Exemption that "a swap that hedges or mitigates the risk of another swap… may qualify as hedging or mitigating commercial risk, so long as the underlying swap… itself is used to hedge or mitigate commercial risk."[12] Under this rule, the underlying swap must itself qualify for the End-User Exemption in order for the initial swap to be exempt from the clearing requirement. In the case of transportation and storage agreements, firms would be hard-pressed to demonstrate the hedging nature of these usage contracts. The intent behind many of these contracts is inherently the use of the underlying asset, and therefore a swap hedging a usage contract would likely not qualify for the End-User Exemption.

Additionally, if the End-User Exemption is not available to a swap hedging a usage contract, there may be financial consequences for commercial parties that were likely not intended by the Commission. Hedging a long-term usage contract with a derivative that requires mark-to-market margining will, perversely, increase volatility of cash flow and earnings even though the derivative reduces the volatility of economic value. This is the opposite of how a hedge should work. This distortion arises because the cash flow and earnings of a usage contract are received and recognized month by month over the life of the contract, while mark-to-market margining requires daily transfers of cash based on the movement in value of the entire derivative. In the case of a five-year usage contract hedged by a margined derivative, for example, an immediate increase in the value of years three through five of the usage contract would require the holder of the usage contract to pay margin immediately (because the derivative will have lost value as the usage contract that it hedges gains value), even though the offsetting value of the contract will be received only beginning in year three.

As was stated above, the Working Group does not believe that Congress intended for usage contracts to be regulated as swaps under the Dodd-Frank Act because they are inherently commercial in nature, regardless of the fee structure. The consequences of classifying usage contracts as commodity options are broad and in some cases superfluous, and the Commission should modify the Final Rule to clarify the treatment of these commercial agreements or to eliminate this interpretive guidance altogether. The Working Group respectfully requests that the Commission reconsider its position in light of the fact that its guidance on the regulatory treatment of usage contracts has the potential to disqualify swaps that mitigate risk arising from these contracts from the End-User Exemption and the *bona fide* hedge exemption of the former Position Limits Rule.

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[11] *See End-User Exemption* at 42,575. The former Position Limits Rule did not explicitly contemplate swaps that hedge other swaps. Without clarification from the Commission, firms would likely have difficulty in demonstrating that a swap used to hedge the commercial risk surrounding a usage contract that is itself a commodity option would have qualified for the *bona fide* hedge exemption (as under the former Position Limits Rule).

[12] *Id.* at 42,574.

ii. The CFTC's Expansion of the Definition of "Commodity Option" Will Create Numerous Technical Challenges for Commercial Entities.

The CFTC's guidance on the regulatory treatment of usage contracts and forwards with embedded volumetric options will also create an excessive burden on the internal processes of commercial energy and other firms. Transactional systems for energy commodities are typically designed to capture most usage contracts in a very different manner from other commodity transactions, including forward contracts and swaps. Natural gas transportation contracts, in particular, are typically reflected in scheduling systems rather than transactional systems. Such systems primarily reflect operational characteristics of these contracts and are not well suited to capture primary economic terms and other valuation data applicable to swaps.

Additionally, some businesses have separate offices, personnel and even IT departments for their physical and financial trading groups, reflecting the inherently distinct nature of these operations. Many also maintain completely separate systems for recording derivative transactions from those used to record physical forward contracts, transportation and storage agreements, also reflecting the distinct nature of these transactions. These organizational, data recording and accounting practices have been in place for many years within the trading units of business organizations, and would be costly and inefficient to restructure.

Furthermore, primary economic terms and valuation data are inapposite to transportation and storage contracts. Commercial firms do not and may not have the systems capability to capture this data. There also is no market for these kinds of contracts. It is unclear how notional and mark-to-market calculations would be performed, and the Working Group considers this to be *de facto* evidence that transportation and storage contracts do not fit in the category of commodity options or swaps.

The Working Group believes that it is excessively burdensome for firms to perform the necessary modifications to internal accounting and other processes that result from classifying usage contracts and forwards with embedded volumetric options as swaps. The Working Group respectfully requests that the Commission consider this, in addition to the concerns stated above and in the COP Comments, in finalizing its interpretive guidance regarding the regulatory treatment of usage contracts and forwards with embedded volumetric optionality.

iv. Non-Severable Embedded Options in Forwards Should Fall Under the CFTC's Trade Option Exemption.

It is not clear from the Final Rule how a forward with an embedded option, or the embedded option itself, is to be treated if it falls outside the scope of the Commission's forward contract exclusion three-factor test.[13] The CFTC states in Footnote 337 of the Final Rule that "[w]hen a forward contract includes an embedded option that is severable from the forward contract, the forward can remain subject to the forward contract exclusion, if the parties document the severance of the embedded option component and the resulting transactions, *i.e.* a forward and an option. Such an option would be subject to the CFTC's regulations applicable to

[13] *See Final Rule* at 48,237.

commodity options."[14] However, it is unclear what treatment is appropriate in the case of a forward with an embedded, non-severable option.

The Commission should clarify that an embedded, non-severable option that falls outside the interpretive guidance is to be treated as a trade option. The remaining portion of the agreement retains its character as a forward and is not a "swap." Without this clarification a contract that is predominantly a forward, but which contains an option that cannot be severed and separately marketed, will presumably be treated as either a swap or a trade option *in toto*, in either case leading to the application of an inappropriate regulatory scheme to what is intended to be an excluded commercial transaction.

v. Trade Options in Nonfinancial Commodities That Are Intended to Be Physically Settled Should Not Be Regulated as Financial Contracts.

In both the Final Rule and the trade option exemption,[15] the Commission identifies all options as "swaps" without distinguishing between those that are intended to result in the physical delivery of a nonfinancial commodity and those that are purely financial contracts. It would be more consistent with the statutory framework for the Commission to treat separately (a) options that are intended to be physically settled from (b) those contracts that do not contemplate physical delivery (either by the terms of the option, or because of the intent of the parties).

Under this analysis, if a contract is an option (but not a "swap" because of 1a(47)(B)(ii)), the Commission retains authority over the agreement pursuant to Section 4c(b).[16] Given that such transactions have historically been treated as commercial and not financial transactions, and because they are extensively used by commercial market participants with little if any connection to financial markets, there is no clear reason a new regime would be necessary for such routine commercial agreements. We are aware that the Commission states in the Final Rule that "the CFTC is not providing an interpretation that commodity options qualify as forward contracts in nonfinancial products."[17] We respectfully submit that the Commission re-visit this question.

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[14] *Id.*

[15] *See Commodity Options Rule* at 25,338.

[16] It should be noted that this approach has the added benefit of not rendering CEA section 4c(b) superfluous or extraneous, which is disfavored in normal canons of statutory construction. *See e.g.*, *Hibbs v. Winn,* 542 U.S. 88, 101 (2004); *United States v. Menasche*, 348 U.S. 528, 538–39 (1955); *Begay v. United States*, 553 U.S. 137, 153 (2008); *Lamie v. United States Tr.*, 540 U.S. 526, 536 (2004); *Microsoft Corp. v. i4i Ltd. P'ship*, 131 S. Ct. 2238, 2248 (2011); and *Corley v. United States*, 129 S. Ct. 1558, 1566 & n.5 (2009). (The U.S. Supreme Court has cautioned that "we are hesitant to adopt an interpretation of congressional enactment which renders superfluous another portion of that same law." *See Mackey v. Lanier Collection Agency & Serv., Inc.*, 486 U.S. 825, 837 (1988)).

[17] *Final Rule* at 48,237.

III. CONCLUSION.

The Working Group supports appropriate regulation that brings transparency and stability to the swap markets worldwide. The Working Group appreciates this opportunity to provide comments on the interpretive guidance in the Final Rule and respectfully requests that the Commission consider the comments set forth herein as it develops its final interpretive guidance regarding these matters.

If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ David T. McIndoe
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Cheryl I. Aaron

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