DLA Piper LLP (US)
500 Eighth Street, NW
Washington, DC 20004
www.dlapiper.com

Christopher A. Schindler
christopher.schindler@dlapiper.com
T 202.799.4582
F 202.799.5000

October 12, 2012

Stacy Yochum
Secretary of the Commission
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 Regarding Rulemaking, 17 Fed. Reg. 48,207 (Aug. 13, 2012) ("Product Definition Rule").

RIN No. 3038-AD46

Dear Ms. Yochum:

Southern California Edison Company ("SCE") respectfully submits these comments in the above-referenced proceeding of the Commodity Futures Trading Commission ("CFTC" or "Commission") pertaining to the definition of a Swap ("Product Definition Rule").[1]

Summary

In these comments, SCE seeks to correct a factual misunderstanding that gives rise to an erroneous conclusion by the Commission with respect to a regulatory product used by SCE. In addition, SCE addresses certain apparent inconsistencies in the interpretive guidance that accompanies the Product Definition Rule which cast doubt on the Commission's intended regulatory treatment of transactions commonly used by SCE. Accordingly, SCE requests clarification and/or modification, as appropriate, to confirm that the following transactions are forward contracts and are therefore excluded from the statutory definition of a Swap:

1. Resource adequacy ("RA") agreements, which are regulatory products used by SCE to comply with rules of the California Public Utilities Commission ("CPUC").

2. Tolling agreements ("TAs"), which are standard commercial arrangements in the electric power industry that establish commercial obligations for the delivery of power from an electric power generating plant.

SCE further requests that the CFTC delete a paragraph in the Product Definition Rule that would regulate TAs and other physical agreements as commodity options if they include storage fees, usage fees, rents, or other analogous charges.

---

[1] In addition to the comments contained in this letter, SCE adopts and incorporates by reference the comments submitted to the Commission by the Edison Electric Institute in its comments to the Product Definition Rule.

Discussion

SCE has participated actively throughout the Commission's process to develop a Swap definition. SCE submitted joint written comments with other California utilities on the proposed rule,[2] and has engaged in a continuing dialogue with members of the Commission and the Commission staff on the unique features of the market and regulatory environment in which SCE procures, sells, transmits, distributes and delivers energy to its customers. SCE notes with appreciation that the explanatory text of the Product Definition Rule reflects this input.[3]

SCE interprets the Product Definition Rule and explanatory statement to support a conclusion that the CFTC intended to exclude from the definition of Swap agreements for the purpose of physical delivery of a commodity. These comments are submitted, therefore, out of concern that the regulatory status of the categories of transactions described below will in some instances be inappropriately cast in doubt and, in other circumstances, may be undermined entirely by certain aspects of the explanatory text. SCE believes this is not the Commission's intent and therefore urges it to issue revised and corrected guidance.

1. Resource Adequacy Agreements

Resource Adequacy agreements are forward contracts for the delivery of a non-financial commodity and, as such, should be expressly excluded from the statutory definition of a Swap. Because the purpose of RA agreements is the transfer of ownership and consumption (*i.e.*, surrender) of a compliance instrument, RA agreements have the same character as the environmental commodities that the Commission exempted from the definition of a Swap in the Product Definition Rule, and they should be treated accordingly.

a. RA agreements are regulatory compliance instruments that allow SCE to meet certain mandatory CPUC rules.

The Commission's discussion of RA agreements reflects a misunderstanding of a key fact about these products. Footnote 340 of the Product Definition Rule indicates that an RA agreement confers on the utility counterparty the right to call on electric power generating capacity.[4] This is inaccurate. The Product Definition Rule states that "[t]he California Utilities enter into resource adequacy agreements to procure electric power generating capacity" and indicates that RA agreements give the California Utilities the "ability to call on the additional 15 to 17% reserve reflected in such an agreement," but that is not the case.[5] RA agreements only provide SCE with the ability to submit a compliance instrument to the CPUC to document its compliance with the CPUC's mandatory RA requirements. They do not confer on SCE the right to call on or dispatch power.

As explained in the California Utilities Comment Letter submitted July 22, 2011, each load serving entity ("LSE") in California "must file a supply plan with the CPUC demonstrating that it has procured sufficient

---

[2] California Utilities Comment Letter (July 22, 2011).
[3] 17 Fed. Reg. 48, 207, at 48,233-35; 48,240-43 (Aug. 13, 2012).
[4] *Id.* at 48,238 n. 340.
[5] *Id.*

capacity resources (including reserves) needed to serve its aggregate system load on a monthly and yearly basis."[6] As the Comment Letter explained, "RA agreements enable an LSE to demonstrate compliance with RA program requirements."[7] However, RA agreements do not include any right to take title to or to dispatch any of the output of the RA resource, whether or not such output is part of the required 15% to 17% reserve margin. By its terms, an RA agreement commits the power generating resource to "deliver the contracted capacity at the direction of CAISO, so that day-ahead and real-time delivery obligations are controlled by CAISO, and not by the California Utilities or other LSEs."[8] Thus, electric power capacity committed pursuant to an RA agreement is subject to dispatch only at the direction of the CAISO, not the LSE. In an RA agreement, the LSE never obtains the right to determine whether and when energy from the RA resource is committed by the CAISO for dispatch into the market, nor does the LSE have the right to call on any reserve power unused by the CAISO.

b. RA agreements are similar to other exempted environmental commodities because transactions involving RA agreements result in physical settlement.

As with Renewable Energy Credits and other environmental commodities, counterparties to RA agreements deliver and consume the instrument "in order to comply with the terms of mandatory or voluntary environmental programs."[9] RA agreements enable SCE to take ownership of a compliance instrument from its counterparty and to "consume" the instrument by submitting it to the CPUC as evidence that SCE has procured sufficient resources to meet the requirements of the RA program. As the Commission opined with respect to environmental commodities, "[t]hese two features -- ownership transfer and consumption -- distinguish such environmental commodity transactions from other types of intangible commodity transactions that cannot be delivered, such as temperatures and interest rates. The ownership transfer and consumption features render such environmental commodity transactions similar to tangible commodity transactions that clearly can be delivered, such as wheat and gold."[10]

Because transfer and consumption is key to understanding the RA program, it is important to be clear about the nature of the delivery obligation under an RA agreement. An RA agreement does not create an obligation between the generation resource and the LSE for delivery of electricity to the LSE from the generation resource. Instead, it obligates the generation resource to deliver to the LSE a compliance instrument that verifies its capability and confirms its obligation to deliver electricity to the CAISO -- ***at the direction of the CAISO***. This arrangement is, as the Commission has noted, akin to that of "physical commodities where ownership is transferred by delivering a warehouse receipt from the seller to the buyer, thereby indicating the presence in the warehouse of the contracted for commodity volume."[11] Here, the seller (the generating resource) transfers a warehouse receipt to the LSE, indicating the availability of generating capacity in the "warehouse" for delivery of the "contracted for commodity volume" at the direction of the LSE's "customer" -- the CAISO.

---

[6] *Supra* n. 2 at 6.
[7] *Id.*
[8] *Id.*
[9] *Supra* n. 3 at 48,233-34.
[10] *Id.*
[11] *Id.* at n. 281.

Once this compliance instrument is transferred to the LSE, the LSE submits the compliance instrument to the CPUC and the LSE's only remaining obligation under the RA agreement is payment. Similarly, once transfer of the compliance instrument to the LSE has occurred, the generating resource's obligation to the LSE is satisfied because, as noted above, RA agreements allow only the CAISO (and not the LSE) to call on energy from the generating resource.

The Commission has indicated that "an agreement, contract or transaction in an environmental commodity may qualify for the forward exclusion from the swap definition if the transaction is intended to be physically settled."[12] RA agreements share this key feature of physical settlement and delivery as the intended purpose of the contract.

c. RA agreements have no embedded optionality and therefore should not implicate the volumetric optionality test in the Product Definition Rule.

An RA agreement does not provide for optionality with respect to delivery of the compliance instrument by the generating resource under the RA agreement. Prior to execution, the LSE and the generating resource negotiate the volume of capacity available under the RA agreement. This volume may be based on atmospheric seasonal conditions, planned yearly maintenance on the generating resource, or remaining uncontracted capacity of the generating resource. Once the RA agreement is executed, the volume and price are fixed, and the LSE's role thereafter is limited to (a) surrender of the compliance instrument to the CPUC and (b) payment for the fixed capacity set forth in the RA agreement. Payment is never based on energy that is dispatched at the direction of the CAISO.

d. Conclusion

RA agreements are regulatory products that allow an LSE to deliver a compliance instrument to the CPUC solely to meet the LSE's regulatory obligation. For the reasons described above, the CFTC should confirm that RA agreements are not Swaps because, like environmental commodities such as Renewable Energy Credits and emission certificates and allowances, they are non-financial forward contracts that result in physical settlement of a compliance instrument.

2. Tolling Agreements

Tolling agreements ("TAs") should be excluded from the definition of a Swap because they are forward contracts for the delivery of non-financial commodities -- electric power and capacity. SCE requests confirmation that the Commission will view TAs as forward contracts, because: (a) any embedded volumetric optionality results from price fluctuations that are outside of the purchaser's control; (b) even if a TA contains severable RA obligations, such RA obligations should themselves be treated as forward contracts; (c) optionality regarding the delivery term is typically based on arrangements to address risks associated with construction of new power plants that are outside the control of the purchaser; (d) optional arrangements to settle environmental compliance obligations either physically or financially are due to regulatory restrictions in California regarding compliance with California's Global Warming Solutions Act of 2006 ("AB32"); and (e) provisions for the payment of storage fees, usage fees, rents or other analogous charges should not cause a contract to be treated as a commodity option.

---

[12] *Id.* at 48,234.

a. TAs with embedded volumetric optionality should not be treated as Swaps.

The CFTC has devised a seven-part test under which a contract can qualify for the forward contract exclusion even if it includes an embedded volumetric option.[13] The seventh prong of this test could be interpreted to prevent most TAs from qualifying as forward contracts even though the predominant feature of those contracts is actual delivery.

The seventh prong provides that, in order for a contract with an embedded volumetric option to qualify for the forward contract exclusion, the volumetric optionality must result from physical or regulatory factors outside the parties' control. Certain bidding practices related to TAs could erroneously be construed as resulting in volumetric optionality under SCE's "control." For example, if SCE bids a generating resource subject to a TA into the CAISO and the resource does not clear the market, the clearing price is outside SCE's control, but SCE's *calculation* of the bidding price is within SCE's control. SCE's bidding price calculation could be interpreted to give SCE control over the volumetric optionality, preventing the underlying TA from qualifying for the forward contract exclusion.

The CFTC should clarify that TAs do not become subject to regulation as Swaps merely because the underlying generation resource is bid into an energy market at a price above the clearing price.

b. TAs that contain severable RA agreements should not be treated as Swaps.

The third prong of the seven-part volumetric optionality test requires that an embedded commodity option "cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded."[14] This language could result in certain TAs being characterized as Swaps merely

---

[13] *Id.* at 48,238. The test provides that contracts with embedded *volumetric* optionality can qualify for the forward contract exclusion when:
(i) the embedded optionality does not undermine the overall nature of the agreement, contract, or transaction as a forward contract;
(ii) the predominant feature of the agreement, contract, or transaction is actual delivery;
(iii) the embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded;
(iv) 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;
(v) the buyer 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 take delivery of the underlying nonfinancial commodity if it exercises the embedded volumetric optionality;
(vi) both parties are commercial parties; and
(vii) **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.**

[14] *Id.* The three-part test related to price optionality, discussed in n. 15, *infra*, includes a similar provision.

because those TAs include separate provisions related to RA agreements that are severable. As explained in Section 1 of this letter, RA agreements should qualify as forward contracts rather than Swaps. Accordingly, even if RA agreements can be severed from a TA, the TA should not be treated as a Swap solely because one of its provisions, the RA agreement, can be severed.

c. TAs with operational and construction performance contingencies are forward contracts because they include a binding delivery obligation.

The CFTC has devised a three-part test for determining when a contract with an embedded commodity option based upon price qualifies for the forward contract exclusion.[15] The second prong requires that embedded options must "not target the delivery term, so that the predominant feature of the contract is actual delivery." This language is troublesome because, under its literal terms, the inclusion of standard commercial provisions intended to address risk and liability associated with the development and construction of a power plant could inappropriately treat an agreement whose overall purpose is delivery of power as a Swap because it contains contingencies that relate to delivery.

TAs related to power plants that have not yet been constructed routinely include provisions that affect the delivery term based on the construction schedule of the project. Although these provisions affect the delivery term by establishing parameters for a project's in-service date, the agreements are nevertheless forward contracts rather than Swaps because the intent of the parties -- and the predominant feature of the contract -- is actual delivery of power from the plant. In some cases, the dates on which energy deliveries commence under a TA for a proposed plant may simply be delayed when construction runs behind schedule. In other cases, a party may actually have an option to terminate the contract if construction is not completed by a specified date. In either case, however, such contingencies do not undermine the intent of the parties to deliver or take delivery of a nonfinancial commodity, and should not subject TAs to regulation as Swaps.

This analysis accords with the CFTC's determination (in the context of the so-called Brent Interpretation) that, "notwithstanding the withdrawal of the Energy Exemption, a failure to deliver as a result of the exercise by a party of a 'bona fide termination right' does not render an otherwise binding delivery obligation as non-binding."[16] As the CFTC has clarified, "certain alternative delivery procedures [including bona fide termination rights] will not disqualify a transaction from the Brent Interpretation safe harbor."[17] Bona fide termination rights include "force majeure provisions and termination rights triggered by events of default, such as counterparty insolvency, default or other inability to perform."[18] The CFTC has further clarified that "a bona fide termination right must be triggered by something not expected by the parties at the time the contract is entered into."

---

[15] *Id.* at 48,237. The three-part test provides that "a forward contract that contains an embedded commodity option or options would be considered an excluded nonfinancial commodity forward contract (and not a swap) if the embedded option(s): (i) may be used to adjust the forward contract price, but do not undermine the overall nature of the contract as a forward contract; (ii) do not target the delivery term, so that the predominant feature of the contract is actual delivery; and (iii) cannot be severed and marketed separately from the overall forward contract in which they are embedded."
[16] *Id.* at 48,230.
[17] *Id.* at 48,229.
[18] *Id.* at 48,230.

TAs often include bona fide termination rights triggered by a generation owner's inability to perform, including inability relating to construction delays. Although such termination rights arguably target the delivery term, the CFTC has recognized that exercise of such termination rights does not render a delivery obligation non-binding. Accordingly, the predominant feature of the contract remains actual delivery. Similarly, the delivery term of certain TAs may be *delayed* based on inability of the generation owner to perform, including inability resulting from construction delays. Although such TAs are delayed rather than terminated, they too include a binding delivery obligation, such that the predominant feature of the contract remains actual delivery.

d. Payment of storage fees, usage fees, rents, or other analogous charges should not cause TAs or other contracts to be treated as commodity options.

The Product Definition Rule includes a three-part test to determine whether certain physical agreements for the supply and consumption of energy will qualify as forward contracts or as commodity options subject to the definition of Swap.[19] The test applies to TAs, natural gas transportation and storage agreements, and may apply to certain electric transmission agreements and other agreements for the *usage* of energy-related facilities.[20]

Although the CFTC's three-part test for physical agreements presumes that certain of these agreements should not be regulated as commodity options, the Product Definition Rule includes a paragraph providing that such agreements will be treated as options if they include "storage fees, usage fees, rents, or other analogous service charges not included in the demand charge or reservation fee..."[21] This paragraph would result in the vast majority of TAs (as well as gas transportation and storage agreements) being regulated as commodity options.

SCE recommends that the CFTC delete the paragraph because it would impose unnecessary burdens on entities that participate in physical energy markets. As written, this definition would encompass a majority of SCE's TAs because TAs often require SCE to pay "usage fees" to cover the variable costs of operating power plants. This would increase transaction costs for SCE, ultimately resulting in higher rates for SCE's customers, whose power needs are often most efficiently served through TA arrangements.

Similarly, the definition could encompass FERC- and state-regulated agreements for electric transmission, natural gas transportation, and natural gas storage. For example, to meet fuel needs for power plants that serve its customers, SCE must arrange firm transportation of natural gas supplies on interstate and intrastate natural gas pipelines. These transportation agreements generally involve both a

---

[19] *Supra* n. 1 at 48,242. The test provides that an agreement will not be an option if: (i) 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; (ii) 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 (iii) 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.
[20] *Id.*
[21] *Id.*

reservation/demand charge and a usage/commodity charge, which must comply with FERC and CPUC rate design principles. SCE believes it would be contrary to the interests of its customers for TAs to bear the costs of CFTC reporting and recordkeeping requirements merely because such agreements contain cost recovery mechanisms mandated by FERC and the CPUC.

Accordingly, SCE respectfully requests that the CFTC delete the paragraph that could subject TAs and other physical agreements that include usage fees and analogous charges to regulation as commodity options subject to the definition of a Swap.

e. TAs that include an option to settle environmental compliance obligations either physically or financially should not be treated as Swaps.

In certain TAs, SCE agreed to take on the financial obligations of generators imposed by California Assembly Bill 32 ("AB32"), which established a compliance program related to greenhouse gas emissions. Under these TAs, SCE has an option to settle these obligations physically (by delivering emission allowances to the generation owner) or financially (by compensating the generation owner for its compliance obligation). SCE reserved the option to settle its obligations financially because, under the AB32 compliance program, the California Air Resources Board ("CARB") limits the number of physical allowances that SCE can hold in its account. These optional features of its TAs are a mechanism to provide SCE with needed flexibility to assure compliance with CARB accounting limitations, and should not prevent them from qualifying for the forward contract exclusion.

The CFTC should confirm that TAs qualify as forward contracts when they include an embedded option to settle environmental compliance obligations either physically or financially (assuming that optionality results solely from regulatory constraints). Treating such TAs as Swaps rather than forward contracts would result in unnecessary compliance costs that would increase SCE's transaction costs, ultimately increasing the rates paid by SCE's customers.

f. Conclusion

For the reasons described above, SCE respectfully requests that the CFTC remove regulatory uncertainty and confirm that TAs will qualify as excluded forward contracts whether or not they contain (a) embedded volumetric optionality resulting from price fluctuations that are outside of the purchaser's control; (b) RA agreements that can be unbundled and sold separately from the TA; (c) optionality regarding the delivery term that addresses risks that are outside the control of the purchaser; (d) provisions for the payment of storage fees, usage fees, rents or other analogous charges; and (e) optional arrangements to settle environmental compliance obligations either physically or financially. Additionally, SCE respectfully requests that the CFTC delete the paragraph related to its three-part test for certain physical agreements that would regulate TAs and other physical agreements as commodity options if they include usage fees or analogous charges.[22]

---

[22] *Id.*

SCE appreciates the opportunity to provide the foregoing comments.

Respectfully submitted,

Christopher A. Schindler of DLA Piper LLP (US)
Mary Anne Mason of DLA Piper LLP (US)

On Behalf of Southern California Edison Company