



April 17, 2014

Ms. Melissa Jurgens, Secretary  
U.S. Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, NW  
Washington, DC 20581

Re: End-User Roundtable – Follow-Up Comments

Dear Ms. Jurgens:

Plains All American Pipeline, L.P. (“Plains”) hereby offers its comments in response to the April 3, 2014 roundtable hosted by the staff of the Commodity Futures Trading Commission (the “Commission”) to discuss Dodd-Frank end-user issues (the “Roundtable”). Plains participated in the Roundtable by teleconference, and we are particularly concerned with one issue that was discussed in the Roundtable: the appropriate regulatory treatment of forward contracts with embedded volumetric optionality. We would like to offer our perspective on this issue as a Dodd Frank “end-user” engaged in physical commodities business which is directly affected by the Commission’s treatment of this issue.

### **Plains’ Business and Reasons for Our Interest**

Plains is engaged in the transportation, storage, terminalling, and marketing of crude oil, as well as in the processing, transportation, fractionation, storage, and marketing of natural gas liquids. We own and operate a diversified portfolio of assets that are engaged in the movement of U.S. and Canadian energy supplies which, on average, handles over 3.5 million barrels per day of crude oil and natural gas liquids. As a midstream company, Plains’ business is largely physical services, and as such, we frequently engage in physical commodity purchase and sale transactions that are forward contracts according to the Commission’s final rule defining the term “swap” for Dodd-Frank purposes.<sup>1</sup> As explained below, due to the nature of our physical business, Plains utilizes forward contracts with embedded optionality. Plains agrees with the sentiments of the various participants in the Roundtable that the Seven Part Test (“Test”) (in particular the seventh prong) that the Commission has put in place to determine whether such forward contracts are transformed into swaps under the Commission’s characterization, by

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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, 48227-48229 (Aug. 13, 2012) (the “Products Rule”) (explaining that a forward contract is a binding obligation to deliver the commodity without any provision for financial settlement where the parties are commercial producers, fabricators, refiners or merchandizers of the underlying commodity that regularly make or take delivery of the subject commodity in the ordinary course of business).

virtue of the existence of such optionality, has proven to be somewhat confusing and unworkable.<sup>2</sup>

### **The Seven Part Test is Problematic for Plains**

Plains has had difficulty interpreting the meaning of “beyond the control of the parties” language in the Test for analyzing our physical contracts. We have also experienced confusion and divergent interpretations among our counterparties as to whether a physical forward contract with embedded volumetric optionality remains a forward contract.<sup>3</sup>

Plains, like other physical energy companies engaged in commodity marketing businesses, frequently utilizes forward contracts with embedded volumetric optionality to address fundamental commercial needs of our physical business and our customers. Such contracts provide us with the ability to allow our customers flexibility to increase or decrease the amount of purchase or sale of a commodity in response to prevailing market conditions. Such contracts are physical contracts that require physical delivery of the commodity. If not for the seventh prong of the Test, these contracts would be unambiguously viewed as forward contracts outside of the definition of a swap.

In particular, Plains’ continues to experience dramatic volumetric volatility in certain areas where horizontal drilling has been employed. As a midstream company, Plains is a physical aggregator of crude oil. We purchase from thousands of wells. Plains Risk Management Policy, which is intended to mitigate risks that are inherent in our marketing, gathering and storage business, requires us to maintain a balanced position between our purchases and sale commitments. In areas where production quantities are consistent, Plains often services our producer customers by entering into long term requirements contracts, whereby Plains will buy all of a producer’s production from a dedicated area. The instability of production quantities in areas that employ horizontal drilling has made these types of contracts difficult for Plains. In order to stay in compliance with our Risk Management Policy and mitigate our risk, Plains has begun to offer our producer customers purchase contracts whereby we commit to purchase a producer’s production within a volumetric range. We understand that our customer’s production will not be consistent from month to month in these areas, and this contractual arrangement is one way that we are able to service our customer’s needs. Although Plains would view production variability as beyond the control of the parties for the purpose of the

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<sup>2</sup> According to this Test, a Forward Contract with volumetric optionality remains a Forward Contract where: (1) the contract retains its Forward Contract nature, with actual delivery intended; (2) the predominant feature is delivery; (3) the optionality cannot be severed and marketed separately; (4) Buyer intends actual delivery if option is exercised; (5) Seller intends actual delivery if option is exercised; (6) Both parties are commercial parties; and (7) Exercise of the option is based primarily on physical or regulatory factors outside of the parties' control. Products Rule at 48238.

<sup>3</sup> This refers to the particularly problematic seventh prong of the Test, which requires that in order to remain a forward, “[t]he exercise or non-exercised 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.” Products Rule at 48238.

seventh prong of the test, our producer customers do not always agree. Our customers have argued that they have some ability to control their own production volume. Producer decisions in this regard could be driven by the current price of crude.

As explained by several other Roundtable participants, we have noticed that:

- (1) in order to comply with the Commission's regulations, regulatory conservatism is guiding many market participants to resolve any ambiguity by defaulting to an outcome whereby virtually all forward contracts with embedded optionality are considered swaps/trade options under the Commission's characterization;
- (2) regarding the seventh prong, some counterparties are seeking representations that, for future transactions, the exercise of an ability to vary the quantity of a physical contract will always be based on factors outside the parties' control; and
- (3) many counterparties understand the Test to have failed when a counterparty has more than one alternative to meet its physical commodity needs, therefore making the choice of supply "within its control."

These concerns lead to problematic outcomes and also results in parties to the same agreement making inconsistent reports on Form TO as to what is included within the scope of the term "swap" and the trade option exemption available to physically-delivering options.

We appreciate the Commission's willingness to discuss issues with this Test at the Roundtable, and agree with the majority of the Roundtable participants in recommending that, at the very least, the Commission should, in the near future, issue a clarifying interpretation giving market participants certainty that physically-delivering contracts featuring volume variability/optionality are not commodity options/swaps when the variation in volume is driven by an entity engaged in a physical business making decisions to serve its physical consumption or marketing needs that are affected by supply and demand. We also believe that the Commission should issue a revised interpretation either adopting this sort of clarification of the established Commission policy regarding the Test or eliminating the seventh prong entirely.

### **The Commission Should Revise/Clarify the Seven Part Test and Make Clear That It Only Applies to Bona Fide Options Embedded in Forward Contracts**

Plains believes that Congress did not intend for physical commodity forward contracts to be considered "swaps" within the meaning of Dodd-Frank, therefore they should not be defined as such by the Commission's regulations or interpretations.<sup>4</sup>

However, if the Commission believes that certain physical options fall within the scope of a "swap," whether they are embedded in a forward contract or not, the first inquiry should be whether an option exists. In its discussion of forward contracts with embedded optionality in the Products Rule, the Commission relied upon its prior *In Re Wright* decision to establish its

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<sup>4</sup> 7 U.S.C. § 47(B)(ii) ("The term 'swap' does not include . . . any sale of a nonfinancial commodity . . . for deferred shipment or delivery, so long as the transaction is intended to be physically settled.").

rules for forward contracts with embedded optionality.<sup>5</sup> In *Wright*, the Commission's fundamental ruling with respect to the contracts in question was that "*no freestanding option had come into being*," and as a result, the contracts in question were forward contracts. The criteria set forth by the Commission for whether a "*freestanding option has come into being*" are: (1) the instrument gives the buyer the right, but not the obligation, to take or make delivery of the commodity; (2) the buyer's losses are limited to a premium paid as consideration for the option seller's performance; and (3) the instrument is purchased by offering a premium as opposed to a down payment on the eventual delivery price.<sup>6</sup> Accordingly, the Commission should clarify that, consistent with *Wright*, the Test should only be applied when a freestanding option actually exists.

As stated above, due to ambiguity of the meaning of the seventh prong, Plains recommends that the Commission eliminate it entirely and instead rely upon the preceding six prongs. In the alternative, Plains supports the suggestion made by several Roundtable Participants that a clarification be issued stating that the seventh prong of the Test is met (and therefor the contract remains a forward contract and is not a swap) when:

- **The optionality – whether a put or a call – is intended to meet the commercial production, consumption, or merchandizing requirements of the option owner's business, which can be reasonably affected by supply or demand conditions; and**
- **The existence of multiple alternatives to address these business requirements, including cases where business judgment is exercised in choosing among alternatives, and such selection is driven primarily by external factors including qualitative factors, does not cause the transaction to fail the test.**

If the Commission or its staff were to issue the requested clarification, physical energy commodity merchants that are parties to forward contracts with embedded optionality (such as Plains) could continue with their commercial businesses with a clearer understanding of the dividing line between swaps/trade options and forward contracts. The requested clarification would also avoid the over-broad application of the commodity option / swap definition to physical transactions that do not qualify as options under well-established Commission precedent.

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<sup>5</sup> Products Rule at 48228 (*citing In re Wright*, CFTC Docket No. 97-02, 2010 WL 4388247 at \*3 (CFTC Oct. 25, 2010)).

<sup>6</sup> *See In the Matter of Cargill, [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) at P 28,425 (Nov. 22, 2000) (citing Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) P 22,718 (Sept. 30, 1985)).*

**Conclusion**

Plains requests that the Commission or its staff clarify the proper scope of the commodity option / swap definition, particularly with respect to the seventh prong of the Commission's Seven Part Test for distinguishing a swap from a forward contract with embedded optionality.

Respectfully Submitted,



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Senior Vice President &  
General Counsel – Commercial & Litigation

CC:  
Acting Chairman Mark P. Wetjen  
Commissioner Scott O'Malia