

Before the  
**Commodity Futures Trading Commission**

Secretary of the Commission  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, NW  
Washington, DC 20581

**COMMENTS OF CERTAIN ARIZONA UTILITY SPECIAL ENTITIES**

**Proposed Rule:** Exclusion of Utility Operations-Related Swaps with Utility Special Entities  
From De Minimis Threshold for Swaps with Special Entities

**RIN NUMBER 3038-AE19**  
79 Fed. Reg. 31,238 (June 2, 2014).

## **INTRODUCTION**

In response to the Commodity Futures Trading Commission (“CFTC” or “Commission”) June 2, 2014 solicitation for comments, the Arizona utility special entities listed below (“AZ Utility Special Entities”) take this opportunity to comment on two issues: (1) the special entity sub-threshold for swap dealers, and (2) the proposed seven-factor test on volumetric optionality. As detailed below, AZ Utility Special Entities strongly support the amendments proposed by the CFTC regarding the special entity sub-threshold for swap dealers, and urge the CFTC to modify the seven-factor test on volumetric optionality.

## **IDENTITY OF COMMENTERS**

The AZ Utility Special Entities submitting these comments are as follows: Aguila Irrigation District, Buckeye Water Conservation and Drainage District, City of Safford, Arizona, Electrical District Number Two of Pinal County, Electrical District Number Three of Pinal County, Electrical District Number Four of Pinal County, Electrical District Number Five of Pinal County, Electrical District Number Six of Pinal County, Electrical District Number Seven of Maricopa County, Electrical District Number Eight of Maricopa County, Harquahala Valley Power District, Maricopa County Municipal Water Conservation District Number One, McMullen Valley Water Conservation & Drainage District, Ocotillo Water Conservation District, Roosevelt Irrigation District, Tonopah Irrigation District, and Town of Thatcher, Arizona. Each of these entities is a municipal electric system, electrical district or irrigation district, in each case created pursuant to Arizona law, and thus is a special entity. Each such entity engages in wholesale power transactions in support of its obligation to provide retail electric service to its citizens and/or customers, and accordingly will be affected by the Commission’s actions in this proceeding.

## COMMENTS

### I. SPECIAL ENTITY AMENDMENTS

The Commission's June 2, 2014 proposed rule would:<sup>1</sup>

amend its regulations . . . to permit a person to exclude utility operations-related swaps with utility special entities in calculating the aggregate gross notional amount of the person's swap positions solely for purposes of the *de minimis* exception applicable to swaps with special entities.

By way of background, Section 1a(49) of the Commodity Exchange Act ("CEA" or "Act") defines the term "swap dealer." CEA Section 1a(49)(D) requires the Commission to exempt from swap dealer designation an entity that engages in a *de minimis* quantity of swap dealing, and to promulgate regulations to establish factors for making a determination to so exempt such entities. Pursuant to this mandate, on April 27, 2012, the Commission adopted Regulation 1.3(ggg), which further defines the term "swap dealer." Regulation 1.3(ggg) became effective on July 23, 2012, and registration as a swap dealer was required beginning October 12, 2012.

Regulation 1.3(ggg)(4) includes an exception from the swap dealer definition for a person that has entered into swap positions connected with swap dealing activities that, in the aggregate, do not exceed, during the preceding 12-month period, either of two aggregate gross notional amount thresholds. The two aggregate gross notional amount thresholds are (i) \$3 billion, subject to a phase-in level of \$8 billion (General De Minimis Threshold) and (ii) \$25 million with regard to swaps in which the counterparty is a "special entity" (Special Entity De Minimis Threshold).

CEA Section 4s(h)(2)(C) and CFTC Regulation 23.401(c) define the term "special entity" to include, among other things, a Federal agency, a State, State agency, city, county, municipality, or other political subdivision of a State. CFTC Regulation 23.401(c) adds "any instrumentality, department, or a corporation of or established by a State or subdivision of a State" to the definition of "special entity."

---

<sup>1</sup> Exclusion of Utility Operations-Related Swaps With Utility Special Entities From De Minimis Threshold for Swaps With Special Entities, 79 Fed. Reg. 31,238, 31,238 (proposed June 2, 2014), (to be codified at 17 C.F.R. pt. 1).

The proposed rule issued by the Commission on June 2, 2014 responds to a July 12, 2012 petition for rulemaking<sup>2</sup> that sought an amendment of Regulation 1.3(ggg)(4). The Petition requested that the regulation be amended to exclude from consideration, in determining whether a person has exceeded the Special Entity De Minimis Threshold, certain swaps related to the utility operations of the Petitioners and certain other special entities (collectively defined as “utility special entities”). The Petition explained that the amendment would increase the number of counterparties willing to enter into transactions necessary to hedge or mitigate commercial risks arising from the utility operations of utility special entities. Although the CFTC took certain intermediary measures to address this issue following receipt of the Petition, this is the first time a rule has been proposed that would make permanent amendments to Regulation 1.3(ggg)(4). In this proposed rule, the Commission states that it:<sup>3</sup>

believes that it is important to address the concerns raised in the [July 12, 2012] Petition regarding the ability of utility special entities to hedge the commercial risks of their electric and natural gas production and delivery businesses including the availability of counterparties with whom utility special entities can enter into customized swaps.

The Commission has identified a number of subjects concerning which it particularly seeks comment, including:<sup>4</sup>

Is it appropriate to treat utility operations-related swaps with utility special entities differently than other swaps with special entities for purposes of determining whether a person is a swap dealer?

...

[U]tility operations-related swaps with utility special entities would be subject to the General *De Minimis* Threshold under Regulation 1.3(ggg)(4)(i), which is currently set at the \$8 billion phase in level. Is that an appropriate threshold, or should the *de minimis* threshold for such swaps be higher or lower?

...

---

<sup>2</sup> Petition for Rulemaking to Amend CFTC Regulation 1.3(ggg)(4), dated July 12, 2012, filed by the American Public Power Association (“APPA”), the Large Public Power Council, the American Public Gas Association, the Transmission Access Policy Study Group and the Bonneville Power Administration.

<sup>3</sup> 79 Fed. Reg. at 31,241.

<sup>4</sup> *Id.* at 31,242-43.

Does the Proposal serve the public interest?

We address these questions below.

As noted, each of the AZ Utility Special Entities is a utility special entity. As such, the AZ Utility Special Entities strongly support the July 12, 2012 Petition and the amendments proposed by this rule. As stated in the petition prompting this proposed rule, utility special entities depend on nonfinancial commodity transactions, trade options and swaps, as well as the futures markets, to hedge commercial risks that arise from their utility facilities, operations and public service obligations. Without repeating each of the facts and arguments set forth in the petition, AZ Utility Special Entities support the reasoning outlined in the petition, and urge the adoption of the amendments proposed by this rule.

It is appropriate to treat utility-operations-related swaps with utility special entities differently from other swaps with special entities for purposes of determining whether a person is a swap dealer. Utility special entities are sophisticated participants in the energy industry's risk mitigation markets and do not require treatment different from investor-owned utilities engaging in the same markets. Utility special entities should not be limited to small numbers of available swap counterparties in regional or local markets that can be quite illiquid. The current rule has the effect of reducing the number of available counterparties, which harms the utility industry by diminishing risk-mitigation options, and puts utility special entities at a disadvantage compared to their investor-owned competitors.

AZ Utility Special Entities support the proposed amended threshold for utility operations-related swaps with special entities. Treating utility special entities equally with other utilities is appropriate and will put them on the same competitive footing.

The proposal addresses an important need and will serve the public interest by facilitating necessary hedging and risk mitigation. Utility special entities play a significant role in the country's utility industry, and in some cases serve otherwise underserved areas. Facilitating the participation of utility special entities in risk mitigation measures which have long been a central part of the industry will contribute to the overall stability of the utility industry.

The Commission should enact each of the amendments that it proposes.

## II. VOLUMETRIC OPTIONALITY

The Commission also requests comments on its proposed interpretation regarding forward contracts with embedded volumetric optionality and the benefits that revising this interpretation will offer utility special entities:<sup>5</sup>

Will utility special entities benefit if the Commission revised its interpretation regarding forward contracts with embedded volumetric optionality as described in the swap definition adopting release? If so, how? Is the seven element interpretation appropriate for determining whether a forward contract with volumetric optionality qualifies for the forward contract exclusion from the definition of a swap? If not, should the Commission revise the interpretation or adopt an alternative standard? If so, what should the revised interpretation or standard be?

AZ Utility Special Entities appreciate the opportunity to comment on this important issue of substantial concern to utility special entities and urge the Commission to modify its proposed seven-factor interpretation.

On August 13, 2012, the agency proposed a seven-part test to determine whether volumetric optionality has the effect of transforming a contract that otherwise would be considered a forward contract into a swap:<sup>6</sup>

The CFTC believes that agreements, contracts, and transactions with embedded volumetric optionality may satisfy the forward exclusions from the swap and future delivery definitions under certain circumstances.

Accordingly, the CFTC is providing an interpretation that 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;

---

<sup>5</sup> *Id.* at 31,243 (internal citation omitted).

<sup>6</sup> *See* Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Agreement Recordkeeping, 77 Fed. Reg. 48,207, 48,238 (Aug. 13, 2012) (internal citations omitted).

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 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;

6. Both parties are commercial parties; and

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.

This seven-part interpretation should be eliminated or modified in order to be meaningful. In particular, factor seven is highly problematic and should be removed. Factor seven provides that, in order to qualify for the forward contract exclusion from the swap definition, optionality embedded in any transaction that otherwise qualifies must be exercised primarily contingent upon *nonfinancial* factors such as physical factors (e.g., weather), or regulatory requirements (e.g., FERC directives), that are outside the control of the parties but may influence supply and demand.

Utility special entities, like other utility entities, regularly enter into forward contracts that contain flexibility in the volume term. The reasons for this are various, including the need to respond to fluctuations in demand caused by factors such as weather and changing circumstances such as plant and transmission outages, as well as the need to minimize costs in accordance with reasonable practice. While utility special entities such as AZ Utility Special Entities lack traditional profit motives, utility special entities would be remiss if they did not engage in

generally accepted forms of cost-control, such as running locally sited generation when market demand and/or congestion drives up the cost of imported power, or conversely opting to schedule energy under a purchased-power contract when it is more economical than other available resources. The reality is that cost-savings and demand factors are interlinked in such a way that they are often inseparable; responsible utility managers consider many factors, including both weather and price, when making decisions as to which of a utility's available resources to utilize at any given time. While the CFTC's current interpretation focuses on non-financial motivations "that are outside the control of the parties," such as weather, congestion, or regulatory actions, cost is part of the decision-making process as well. Any utility making a reasoned decision must weigh all of these factors as elements of a single picture. The ability of a utility purchaser to decide when to schedule energy deliveries (and when not to) for reasons that include the relative price of the energy is a common, normal feature of many purchased-power contracts, and does not change the fundamental nature of the transaction from a physical forward contract to a financial one that should be regulated as a swap.

While the intent of the CFTC in proposing the seven-factor test was to clarify when a transaction with optionality of the volume term should be considered a swap rather than remaining a forward contract, the seventh factor contributes to rather than resolves uncertainty. By failing to acknowledge the interlinked nature of factors such as weather and cost, as well as the fact that every reasonable utility must weigh all such factors when making decisions as to which of its available resources to utilize at any given time, the seventh factor makes it even harder to distinguish a forward contract from a swap when embedded volumetric optionality is present. This increase in uncertainty inevitably exacerbates the hazard of arbitrary or inaccurate distinctions on the part of regulated entities as well as CFTC enforcement staff. It requires that the CFTC not only identify the intent of the parties when exercising volumetric optionality, but distinguish accurately between a cost-based motive and a motive ostensibly "outside the control of the parties." Where both are present, it would require the CFTC to weigh the potential predominance of one over the other. (It appears the CFTC would ironically need to create a *second* seven-factor test just to apply the first one; how else will it distinguish a predominant motive?) Furthermore, it may be a hollow hope to presume that one factor predominates over another when reasoned utility decisions are necessarily multi-dimensional. Whereas this is not the case with financial speculators, multi-dimensional decision-making is a daily reality in the



utility industry. Reliability, cost prudence, and public service obligations are necessarily interdependent.

AZ Utility Special Entities also offer support for the comments of APPA and the Not-for-Profit Electric Associations (“NFP Electric Associations”) on this subject, both in RIN 3038-AD62 and in this proceeding. The comments of APPA and the NFP Electric Associations provide additional bases for eliminating the seventh factor. The NFP Electric Associations submitted comments dated October 12, 2012 in RIN 3038-AD62 that sought the withdrawal of the seventh element of the CFTC’s regulatory interpretation. We understand that similar comments to be filed in this docket on July 2, 2014 will do likewise. In their previous comments in this docket, the NFP Electric Associations identified important additional ambiguities and false assumptions entailed by the seven-factor interpretation<sup>7</sup> that are not detailed herein, but to which the Commission should be alert. AZ Utility Special Entities generally support the comments of both the NFP Electric Associations and APPA regarding the CFTC’s seven-factor interpretation on volumetric optionality.

### III. CONCLUSION

Thank you for the opportunity to comment on this important rulemaking. AZ Utility Special Entities appreciate the Commission’s attention to these matters. Please do not hesitate to contact us with any questions.

Respectfully submitted,

*/s/ Lisa G. Dowden*

---

Lisa G. Dowden  
Margaret A. McGoldrick  
Melissa E. Birchard  
SPIEGEL & MCDIARMID LLP  
1875 Eye Street, NW, Suite 700  
Washington, DC 20006  
Phone: (202) 879-4000

Attorneys for AZ Utility Special Entities

Dated: July 2, 2014

---

<sup>7</sup> Comments of the NFP Electric Associations at 12-13.