FINAL

15000 Commerce Parkway, Suite C
Mt. Laurel, NJ 08054

July 2, 2014

Ms. Melissa Jurgens, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581
Telefacsimile: (202) 418-5521
Email to secretary@cftc.gov and electronically to http://comments.cftc.gov

Re: Comments of the International Energy Credit Association on CFTC "Exclusion of Utility Operations-Related Swaps With Utility Special Entities From De Minimis Threshold for Swaps with Special Entities," (the "Proposed Rule"), RIN 3038-AE19, 79 Fed. Reg. 31238 (issued June 2, 2014)

Dear Ms. Jurgens:

I. Introduction.

The International Energy Credit Association ("IECA") is an association of over 1,400 credit, risk management, legal and finance professionals that is dedicated to promoting the education and understanding of credit and other risk management-related issues in the energy industry. For over ninety years, IECA members have actively promoted the development of best and industry standard practices that reflect the unique needs and concerns of the energy industry. Our members' concerns regarding the relevant rulemakings that followed the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("DFA") have led us to submit to the Commodity Futures Trading Commission ("CFTC" or "Commission") numerous comments on various proposed rulemakings, as well as requests for no action relief and petitions in support of relief requests sought by other energy companies and trade groups, many of which have yet to be addressed by the Commission Staff.

The IECA seeks to protect the rights and advance the interests of the commercial end-user community that makes up the majority of its membership. IECA membership includes representatives of many small and large energy companies all of whom have a fundamental mission of providing safe, reliable, and reasonably priced energy commodities that American businesses and consumers require for our economy and our livelihood. Most of the IECA's members are representatives of commercial end-users,

which rely on swaps to help them mitigate and manage (i.e., hedge) the risks of energy commodity price volatility to their physical energy businesses.

Correspondence with respect to these comments should be directed to the following individuals:

Zackary Starbird	Phillip G. Lookadoo, Esq.
Member of the Board	Reed Smith, LLP
International Energy Credit Association	Suite 1100 East Tower
30 S. Wacker Drive, Suite 900	1301 K Street, NW
Chicago, IL 60606	Washington, DC 20005
Phone: 312-594-7238	Phone: 202-414-9211
Email: zack.starbird@bp.com	Email: plookadoo@reedsmith.com

II. **Comments on the Proposed Rule.**

The IECA commends the Commission for seeking to redress the potentially ruinous risks that Rule 1.3(ggg)(4)(i) currently places on municipal utilities by freezing them out of hedging. Commercial end users are not available as swap counterparties to municipal utilities, because they do not wish to become swap dealers under the existing rule. Similarly, the quasi-fiduciary duties owed by swap dealers render transactions between swap dealers and municipal utilities significantly more expensive, when swap dealers elect to accept those risks by dealing with municipal utilities.

A. **"Special Entity" De Minimis Threshold for Swap Dealing to Government-Owned Electric Utilities**

Under the Proposed Rule, solely for purposes of assessing whether a person's swap dealing activity exceeds the $25 million aggregate gross notional amount threshold for swap transactions with special entities, such person may exclude "utility operations-related swaps" in which the counterparty is a "utility special entity." This exclusion subjects the utility operations-related swaps, entered into by a person with a counterparty that is a utility special entity, to the same (currently) $8 billion de minimis threshold under Rule 1.3(ggg)(4) (the "General De Minimis Threshold") to which all of that person's other "swap-dealing activity" swaps are subject. For this reason, the IECA supports this part of the Proposed Rule.

In fact, the IECA recommends that utility operations-related swaps entered into by a person with a utility special entity, in connection with such person's swap dealing activities, should be treated no differently than any other swap such person may enter into in connection with its swap dealing activities.

B. **The Commission's FPA §201(f) Exemptive Order**

The Commission's Order Exempting, Pursuant to Authority of the Commodity Exchange Act, Certain Transactions Between Entities Described in the Federal Power

Act, and Other Electric Cooperatives, 78 Fed. Reg. 19670 (the "201(f) Order"), effective April 2, 2013, "exempts, pursuant to [CEA §§] 4(c)(1) and 4(c)(6), from all requirements of the CEA and Commission regulations issued thereunder, except those specified below, all Exempt Non-Financial Energy Transactions (as defined below) entered into solely between Exempt Entities (as defined below), retroactive … and subject to certain conditions … ." (78 Fed. Reg. 19688)

The IECA recommends that the Commission use defined words and terms in its Final Rule that are consistent with the usages made of them in the 201(f) Order. The 201(f) Order applies to transactions between all if not most Utility Special Entities, and the Final Rule should make the lines between set and subset clear, rather than obscure.[1]

C. **Reasonable Reliance on Representations**.

In the preamble to the Proposed Rule, the Commission states that entities may rely on representations provided by counterparties in connection with such counterparties' status as "utility special entities" and such swaps as "utility operations-related swaps." The revised text for Section 1.3(ggg)(4) set forth in the Proposed Rule does not, however, include such permitted reliance in the revised regulations.

The IECA believes this is a significant departure from the approach taken by the Commission in other contexts, such as in Part 23 of the Commission's regulations in which a swap dealer is expressly allowed to rely on representations of certain facts by counterparties. Not including the ability to rely on representations as part of the rule itself may discourage entities from relying on the rule at all, given the consequences of not satisfying the conditions of the Proposed Rule. Similarly, not including the ability to so rely on representations of a counterparty as part of the Proposed Rule leaves the reliance issue open to interpretation by the Commission and others, and creates a difference between analogous Commission rules, any of which could be seized upon to show that reliance on such representations with respect to utility special entities is not permitted by the Commission's rules.

Accordingly, similar to the language the Commission has established in Section 23.402(d) and elsewhere in its regulations, the IECA recommends adding the following text as a new Section 1.3(ggg)(4)(i)(B)(6):

> "*Reasonable reliance on representations.* A counterparty to a utility operations-related swap that is not a utility special entity may rely on the written representations of its counterparty that is a utility special entity to satisfy its due diligence requirements under this subpart, unless it has information that would cause a reasonable person to question the accuracy of the representation."

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[1] Unfortunately, language in the Supplementary Information in the Proposed Rule raises questions. For example, footnote 14 at 79 Fed. Reg. 31239 says that under Staff Letter 12-18 "[e]ither or both parties to the swap could be a utility special entity." In fact, this should not be the case for 201(f) entities, which would be most if not all Utility Special Entities; the 201(f) Order and not Staff Letter 12-18 (when it was in effect) would apply.

D. **Question 8: The De Minimis Threshold.**

The Proposal would allow persons to, in effect, treat utility operations-related swaps in which the counterparty is a utility special entity like swaps with a counterparty that is not a special entity in determining whether the person has exceeded a de minimis threshold under Regulation 1.3(ggg)(4)(i)(A). Thus, utility 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? What considerations support using a different amount? Should the de minimis threshold for utility operations-related swaps be set at $3 billion, the level of the General De Minimis Threshold without application of the $8 billion phase-in level, in light of the special protections afforded to special entities under the CEA? Should the threshold be set at an amount equal to a percentage of the gross notional amount of the General De Minimis Threshold, such that an increase or decrease in the gross notional amount of the General De Minimis Threshold would result in a proportionate change in the de minimis threshold for utility operations-related swaps?

IECA strongly supports utility operations-related swaps with utility special entities being subject to the General De Minimis Threshold. IECA believes that the Commission's rationale for subjecting such swaps to the General De Minimis Threshold is correct -- that utility special entities are sophisticated market participants, just like non-government-owned utilities, and they have a compelling need for liquidity in utility operations-related swaps. Subjecting swaps with utility special entities to a separate de minimis threshold would result in three separate thresholds that market participants would have to monitor for compliance. Such additional complication would likely only limit the number of potential counterparties willing to enter into swaps with utility special entities and, instead of furthering the purposes of the DFA, would likely undercut the goal of the Proposed Rule. The Commission's rationale for the Proposed Rule supports the logic of providing the same de minimis threshold for utility special entities as the General De Minimis Threshold.

Further, the IECA strongly encourages the Commission to revisit the General De Minimis Threshold and eliminate any automatic reset to a lower threshold. A change to the General De Minimis Threshold should only occur through deliberate Commission action. The automatic reduction in the General De Minimis Threshold, which could occur in 2017, has created significant regulatory uncertainty in the energy swaps markets, and has already caused market participants to curtail their hedging activity, which has further eroded liquidity in many energy derivatives. The automatic drop of the General De Minimis Threshold from $8 billion to $3 billion would also undercut the impact of the Proposed Rule by limiting potential counterparties for utility special entities.

In contrast to swaps based upon financial commodities that have a set notional value, the notional value of a swap that references a physical commodity is driven in large part by the underlying price of the commodity. Given the volatility in energy

commodities, the Commission cannot know how many entities would be affected by an automatic drop in the General De Minimis Threshold in 5 years, particularly when that drop is more than 60 percent.

The IECA strongly encourages the Commission to amend rule 1.3(ggg)(4) to eliminate the automatic reduction of the General De Minimis Threshold from $8 billion to $3 billion. Instead, the Commission should keep the General De Minimis Threshold set at $8 billion and only change that amount, up or down, based upon compelling and reliable swap market data and market considerations.

The IECA believes that a dramatic reduction in the General De Minimis Threshold will not result in more entities registering as swap dealers, but will instead result in a dramatic reduction in market participants, fewer available counterparties who are not banks, less liquidity in energy swaps and potentially greater volatility in energy prices for consumers.

E. **Question 10: Specifying Books and Records**.

The Commission should not specify any additional books and records that a person must maintain to substantiate that the person may rely on the Proposed Rule. However, should the Commission specify any additional books and records as being required, the IECA respectfully requests the Commission not repeat the deliberate vagueness of Rule 45.2.[2]

F. **Question 15: Notice Requirement in Regulation 1.3(ggg)(4)(i)(B)(4)**.

The Commission attempts to justify the additional notice obligation in Regulation 1.3(ggg)(4)(i)(B)(4), requiring any person relying on the utility operations-related swap exclusion to provide electronic notice to the National Futures Association of a "Notice of Reliance on Exclusion for Utility Operations-Related Swaps with Utility Special Entities, as necessary because "it is important that the Commission be able to know who the persons are that rely on the exclusion under the Proposal to monitor compliance with the swap dealer registration requirement and better ensure that the exclusion under the Proposal serves the intended purpose of enabling utility special entities to manage

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[2] The Final Rules on Swap Data Recordkeeping and Reporting Requirements of the Commission under DFA provide: "**§ 45.2 Swap recordkeeping.** (b) *Recordkeeping by non-SD/MSP counterparties.* All non-SD/MSP counterparties … shall keep full, complete, and systematic records, **together with all pertinent data and memoranda**, with respect to each swap in which they are a counterparty, including, without limitation, all records demonstrating that they are entitled, with respect to any swap, to elect the clearing requirement exception in CEA section 2(h)(7)." (Emphasis added.) But the Commission's text accompanying the Final Rules provides: "The Commission also does not believe that it should specifically delineate the meaning of 'all pertinent data and memoranda.'" 77 F.R. 2141 col. 3. In the face of this deliberate vagueness, , market participants must perform their own predictions of the Commission's expectations.

operational risks in a cost-effective way." (See Question 15 in the Proposed Rule preamble 79 Fed Reg at 31243.)

The Commission has not explained why monitoring compliance with the swap dealer registration requirement is any more significant with respect to utility operation-related swaps with utility special entities than monitoring compliance with the swap dealer registration requirement for all other swaps. So the IECA submits that explanation does not justify treating utility operations-related swaps differently than other swaps.

Moreover, if the Commission's real objective is to ensure that the exclusion under the Proposed Rule actually results in increased availability of counterparties for utility special entities to enter into utility operations-related swaps, then the IECA submits that no additional regulatory burdens should be placed on utility operations-related swaps with utility special entities than are placed on other swaps.

If the Commission's Proposed Rule does not result in additional availability of counterparties to enable utility special entities to hedge their utility operations-related risks, the Commission can be sure that utility special entities will let the Commission know. Utility special entities are, as the Commission has noted, sophisticated parties and they have submitted numerous comments already to this Commission noting that they are unable to hedge their utility operations-related risks due to the lack of available counterparties under the Commission's rules.

The IECA submits that neither of these explanations justify any additional regulatory burden on utility operations-related swaps with utility special entities. On this basis, and in order to ensure the increased availability of counterparties for such swaps, the IECA recommends eliminating the notice and attestation requirements of proposed Regulation 1.3(ggg)(4)(i)(B)(4).

Regarding the Commission's burden estimates associated with the Proposed Rule, the IECA believes that the estimated 100 impacted persons grossly understates the widespread impact this rule will have on the potential counterparties of utility special entities. *See Commission's Supporting Statement for New and Revised Information Collections*, ICR Reference No. 201405-3038-001 (May 28, 2014). In this regard, the IECA understands that some industry participants are estimating there could be more than 10,000 impacted persons. *See* NFP Electric Coalition Comments to the Proposed Ruel (July 2, 2014).

In addition, the IECA believes that the Commission has not adequately evaluated the burden of using the National Futures Association's existing electronic filing system. A large portion of the industry is not currently using this system. Accordingly, new accounts will need to be established and maintained along with other system and operational requirements as set forth on the National Futures Association's website (*see* https://www.nfa.futures.org).

G. <u>Question 18: Embedded Volumetric Optionality</u>.

Utility Special Entities would benefit from revision of the Commission's embedded volumetric optionality test, as would all other market participants and the public that pays for power and products made more expensive and volatile by those tests. Several factors of the 7-Factor Test make it inappropriate for determining forward contract status, and the Commission should adopt an alternative test, as detailed below.

i. <u>7-Factor Test for Embedded Volumetric Optionality</u>

The 7-Factor Test applicable to "forward contracts with embedded volumetric optionality" is set forth in the CFTC's interpretation of Commodity Options Embedded in Forward Contracts, which is contained in the *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48,208 at 48,237 (August 13, 2012) ("<u>Swap Definition Final Rule</u>").

In the Swap Definition Final Rule, the CFTC set forth the following 7-Factor test for assessing whether a forward contract with embedded volumetric optionality continues to satisfy the terms of the forward contract exclusion from the swap and future delivery definitions, or should be considered a swap. Therein the Commission provided the following interpretive guidance (footnotes omitted):

> "The CFTC also is providing an interpretation, in response to commenters, with respect to forwards with embedded volumetric optionality. Several commenters asserted that agreements, contracts, and transactions that contain embedded ''volumetric options,'' and that otherwise satisfy the terms of the forward exclusions, should qualify as excluded forwards, notwithstanding their embedded optionality. 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;
>
> 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;
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> 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."

ii. Concerns with Factors 1 and 2 of the 7-Factor Test

The first two factors of the 7-Factor Test state that "1. The embedded optionality does not undermine the overall nature of the agreement … as a forward contract; and 2. The predominant feature of the agreement … is actual delivery." (77 Fed. Reg. 48238) With that part of its guidance, we agree with the CFTC.

CFTC interprets Factors 1 and 2 as requiring a "binding, albeit deferred, delivery obligation." (77 Fed. Reg. at 48238). With that part of its guidance, we also agree with the CFTC.

We have been advised that the Staff of the CFTC has taken the position in various meetings with market participants that the "delivery of a *non-nominal* volume of a nonfinancial commodity" is required for a transaction to be a "forward contract" and without such an obligation, one does not even get to apply the 7-Factor Test for volumetric optionality with respect to "commodity options embedded in a forward contract," because such a transaction does not involve a forward contract, but is simply a commodity option, and is therefore a swap.

The IECA objects to the mischaracterization of such commercial transactions entered into between commercial parties in order to achieve actual delivery of the nonfinancial commodity, which includes a non-nominal or zero volume at different times during the term of that transaction, as something other than a forward contract with embedded optionality.

We suggest that application of the Commission's various tests for forwards with embedded optionality can achieve the Commission's objectives with respect to speculative transactions, while simultaneously acknowledging that various commercial participants use forward contracts that include non-nominal or zero delivery obligations at various times during the terms of those forward contracts, to meet their physical requirements for nonfinancial commodities.

Doing so will require clarification of some portions of the Commission's interpretative guidance in the Swap Definition Final Rule. As one example, the following text regarding the 7-Factor Test would likely require some further explanation (77 Fed. Reg. 48239): "Where an agreement, contract, or transaction requires delivery of a non-nominal volume of a nonfinancial commodity, even if an embedded volumetric option is exercised, the CFTC believes that the predominant feature of the contract, notwithstanding the embedded volumetric optionality, is actual delivery. This is the case in many forward contracts that have an embedded option that allows a party to buy or sell an additional amount of a commodity beyond the fixed amount called for in the underlying forward contract." (Emphasis added.)

We note that the CFTC's interpretative guidance does allow a "nominal or zero delivery" to be part of a forward contract in a "full requirements contract" (and perhaps also in the context of a contract for "reserves" procured to meet a "regulatory requirement" or to address "physical factors beyond the control of the parties" as described in Footnote 340). In the further interpretations to explain how the CFTC would treat a full requirements contract, the CFTC said (77 Fed. Reg. at 48239): "Based upon this description, the CFTC believes that a going commercial concern with an exclusive supply contract has no option but to get its supply requirements met through that exclusive supplier consistent with the terms of the contract. Any instance where nominal or zero delivery occurred would have to be because the commercial requirements changed or did not materialize. Furthermore, any variability in delivery amounts under the contract appears to be driven directly by the buyer's commercial requirements and is not dependent upon the exercise of any commodity option by the contracting parties." (Emphasis added.)

The position requiring "delivery of a non-nominal volume" that we understand is being expressed by the Staff of the CFTC (as discussed in the two preceding paragraphs) is also inconsistent with the way electric utilities purchase electricity (as described more fully herein), because utilities enter into multiple contracts with different companies owning electric generating facilities, instead of one full requirements contract, and the contracts with many of those generating companies will allow "nominal or zero delivery" in order to meet the electric utilities' commercial needs.

Consider, for example, an electric utility (Utility X) serving thousands of customers with an aggregate load (combined requirement) on an average day of 5,000 Megawatts (MW) that can rise up to 10,000 MW on an extremely hot day (due to increased air conditioning load, etc.).

Under the CFTC's interpretative guidance, if Utility X had one contract with one supplier (Supplier W) capable of delivering up to 10,000 MWs in any hour, and if that one contract obligated Supplier Y to meet the "full requirements" of Utility X, then that contract would not be a swap, but would likely qualify for the forward exclusion from swap regulation, even if the volume during any hour fell to a nominal volume or zero.

Similarly, under the CFTC's interpretative guidance, if Utility X had two contracts, one contract with Supplier Y for a "fixed amount" of 3,000 MW, plus an option to purchase an additional 2,000 MW, and a second contract with Supplier Z for a fixed quantity of 2,000 MW, plus an option to purchase an additional 3,000 MW, then, assuming the CFTC would agree that both contracts "require delivery of a non-nominal volume," then those two contracts would not be swaps under the CFTC's interpretation and would likely qualify for the forward exclusion from swap regulation.

Unfortunately, our exemplary Utility X does not fare as well under the interpretative position being taken by members of the Staff of the CFTC requiring "delivery of a non-nominal volume," when it procures the 10,000 MW of electricity its customers require by entering into as many as 100 separate power purchase agreements (PPAs) with each of 100 different generating companies, each owning a power generating facility. In a typical electric utility's portfolio of supply contracts, some of suppliers own and operate large generating facilities capable of generating several hundred MWs of power, while many other suppliers own and operate much smaller generating facilities capable of generating no more than 15 or 20 MW.

Several of those generating companies will be called upon by Utility X under their respective contracts to generate electricity during every hour of every day to produce the "fixed volume" of 5,000 MW that the customers of Utility X require every hour of every day.

Several of the other generating companies will not be called upon by Utility X under their contracts to generate electricity until the temperature rises (or falls) during certain hours of any day and the requirements of the customers of Utility X exceed the fixed 5,000 MW level.

To Utility X, those generating companies called upon to deliver a "fixed volume" of electricity every hour of every day are forward contracts, because "the predominant feature of [all of such] contracts is actual delivery."

To Utility X, those generating companies who generate zero electricity during many hours of many days during the term of their contracts, i.e., a "nominal or zero delivery," are nevertheless subject to "a binding, albeit deferred, delivery obligation" on any day when the customers of Utility X require more than 5,000 MW of electricity and Utility X calls upon one or more of those generating companies to deliver electricity to Utility X to meet the commercial needs of Utility X and its customers. From the perspective of Utility X, all of such contracts should be forward contracts, because "the predominant feature of [all of such] contracts is actual delivery" and both the buyer (Utility X) and each seller under those contracts intend to take and make delivery of that nonfinancial commodity (electricity) when called upon by Utility X.

And yet, under the position being taken by members of the Staff of the CFTC, for those contracts under which a "nominal or zero delivery" WILL occur on many days of

any year, such contracts cannot be forward contracts, because they do not always require "delivery of a non-nominal volume" or a "fixed amount" and so they must be swaps.

The IECA objects to this position being taken by members of the Staff of the CFTC, whether based on an interpretation of the Commodity Option Final Rule[3] or Factors 1 and 2 of the 7-Factor test for volumetric optionality, because that Staff position is directly contrary to the Commission's own words in the Swap Definition Final Rule, as well as the commercial purchasing practices of an entire industry. The CFTC Staff's interpretation simply does not work for the typical electric utility in the US, which is concerned with assuring it can deliver power to its customers and which has contracts with a hundred or more suppliers of many different sizes, some of whom will deliver "nominal or zero" volumes at various times during the course of each year.

iii. Suggested Resolution of Concerns Regarding the First Two Factors of the 7-Factor Test

The IECA would support deleting that portion of the CFTC's interpretation of Factors 1 and 2 that appears to the Staff of the CFTC to "require delivery of a non-nominal volume" or requires delivery of a "fixed amount" and clarifying that a forward contract between commercial participants, the predominant feature of which is actual delivery of a nonfinancial commodity, can provide for a nominal or zero volume at various times during the term of that forward contract. Alternatively, having the CFTC provide additional interpretative guidance indicating that zero delivery or nominal delivery under one or more supply contracts will not cause such contracts to fail to satisfy Factors 1 and 2 so long as the underlying contracts do impose a binding, albeit deferred, delivery obligation on the supplier of the nonfinancial commodity so that if the purchaser of that commodity calls upon the supplier to deliver the nonfinancial commodity, then that contract will result in physical delivery of the nonfinancial commodity.

iv. Concerns with Factor 7 of the 7-Factor Test

Factor 7 of the 7-Factor Test requires that "exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors or regulatory requirements outside the control of the parties, which are influencing demand for, or supply of, the nonfinancial commodity." This Factor 7 of the 7-Factor test also fails to address adequately the commercial needs of the electric industry.

In our hypothetical example shown above, when the requirements of Utility X's customers rises from 5,000 MW to 5,500 MW, it is true that the increase in quantity of electricity to be purchased by Utility X will require the exercise of the embedded optionality based "primarily on physical factors or regulatory requirements outside the control" of Utility X, but the decision of which of its multiple suppliers to call upon (in the absence of any transmission or system reliability constraints) will be purely economic.

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[3] Commodity Options, 77 Fed. Reg. 25310 (April 27, 2012) ("Commodity Options Final Rule").

Utility X will look at the stack of contracts capable of supplying up to 5,000 MW, which are available to supply the additional 500 MW of electricity required by its customers, and Utility X will select the cheapest contract (subject to credit risk/exposure considerations). If additional electricity in excess of the electricity available under the cheapest contract is required to meet the requirements of Utility X's customers, then Utility X will call on the seller under the next cheapest contract and will continue to work its way, on a purely economic basis, through the remaining contracts in its stack of suppliers until all the electricity required by the customers of Utility X has been delivered.

Notably, regarding the "non-exercise" requirement in Factor 7, one of the sellers ("Seller 17") who included volumetric optionality in its contract with Utility X may not know that Utility X purchased electricity from one or more other suppliers on a day when Utility X did not exercise the optionality under its contract with Seller 17, rather than exercising the optionality under Utility X's contract with Seller 17, much less know the reason that Utility X chose the "non-exercise" of the optionality under its contract with Seller 17.

It is equally unclear what regulatory consequences result for a party, for example a supplier we will call Seller 17, it that party believes (whether such belief arises as a result of a contractual representation, due diligence, historical course of dealing, or some other factor) that, at the time its transaction is entered into with Utility X, that the transaction satisfies Factor 7 of the 7-Factor Test, which belief turns out to be incorrect based on the reason that Utility X elects the "exercise or non-exercise" of its transaction with Seller 17 on some future date.

v. Suggested Resolutions of Concerns Regarding Factor 7 of the 7-Factor Test

The IECA supports deleting Factor 7 of the 7-Factor Test. From the IECA's perspective, this Factor 7 creates substantial uncertainty and ambiguity with respect to whether any transaction can satisfy the requirements of Factor 7. First, and foremost, the test for whether a transaction is a forward contract should be ascertained at the time the transaction is entered into, not at some distant date when the commercial end-user who requested the optionality in its transaction elects to exercise or not exercise that optionality.

Alternatively, the IECA would support a clarification of Factor 7 of the 7-Factor Test that says: "The volumetric optionality is included in a forward contract, at the time of execution of such contract, in order to meet the commercial needs of one of the parties to that forward contract and not for any speculative or investment purpose of that party."[4]

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[4] In the interpretative guidance included in the Swap Definition Final Rule, the Commission elected not to regulate as swaps certain commercial transactions even if such transactions have attributes that could be viewed as falling within the swap definition. Because such transactions are used to meet the commercial parties' needs, such forward contracts are similar to the Commission's category of excluded

As a further alternative, the IECA would support a replacement of the 7-Factor Test with the following test:

> "Any purchase or sale of a non-financial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled, including any stand-alone or embedded option for which –
> (I) exercise results in a physical delivery obligation;
> (II) cannot be severed or marketed separately from the overall transaction for the purpose of financial settlement; and
> (III) both parties are commercial participants.[5]

vi. Commodity Options for Physical Delivery of a Nonfinancial Commodity Between Commercial Market Participants, which are not Investment Vehicles, Should Not be Treated as Swaps

The IECA supports an additional finding that should be added to the Commission's interpretative guidance in the Swap Definition Final Rule, namely that Commodity Options, which provide for physical delivery of a nonfinancial commodity between commercial market participants as the parties to such Commodity Option, will not be treated as swaps.

The IECA submits that commodity options that qualify for the trade option exemption under Section 32.3 of the Commission's regulations ("Trade Options"), just like forward contracts, are not intended to transfer price risk from one party to another, but are simply commercial transactions intended to transfer physical delivery and ownership of a physical commodity from one party to another.

Commercial market participants utilize Trade Options, i.e., forward contracts with embedded volumetric or price optionality, no differently than any other physical forward contract to procure or sell quantities of a nonfinancial commodity that is needed for its commercial business and not as a means of mitigating volatility or other financial risks or for speculative investment purposes. As such, Trade Options should not be treated as swaps.

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commercial transactions. The IECA's proposed clarification of Factor 7 of the 7-Factor Test borrows from the enumerated attributes the Commission considered common to excluded commercial agreements. See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,208 at 48,247 (August 13, 2012).

[5] See Section 354 of H.R. 4413 approved by the House Agriculture Committee on April 9, 2014.

vii. Other Reasons Why It Matters that Commodity Options for Physical Delivery of a Nonfinancial Commodity Between Commercial Market Participants Not be Treated as Swaps

The plain language of the definition of "Trade Option" also provides a basis for the categorical exclusion of Trade Options from position limits. By its terms, Trade Options are commercial transactions, because at least one of the counterparties must be a commercial participant (a producer, processor, commercial user of, or merchant handling, the underlying physical commodity or a product or byproduct of such physical commodity), and such commercial participant is offering or entering into the commodity option transaction solely for purposes related to its business as such. Since Trade Options are commercial and not speculative, it is unclear how subjecting Trade Options to position limits would further the Commission's efforts to "diminish, eliminate, or prevent excessive speculation."

In fact, the Commission should exclude Trade Options from position limits to avoid imposing regulations that are designed to deter excessive speculation on transactions that are fundamentally commercial.

Moreover, including Trade Options within the position limits regime subjects them to a form of analysis that they simply do not fit. The CFTC's proposed Position Limits rule defines a significant exemption from such limits on positions, arising from the statutory text, for "bona fide hedges." Although Trade Options are, by definition, commercial transactions, they may not meet the requirements for a bona fide hedging exemption to the CFTC's proposed Position Limits. As was noted at the Roundtable, commercial parties to a Trade Option will not be using Trade Options to hedge the risk of a physical forward transaction, because <u>the commercial parties to the Trade Option view the Trade Option itself as the physical forward transaction</u>.

Since the primary exclusion allowing a party to a swap to exceed a Position Limit is the bona fide hedging exemption, and since Trade Options by their very definition are used to provide physical delivery, not a hedge of a financial risk related to a physical delivery, there is a substantial likelihood that the bona fide hedging exemption will not be available to allow a commercial participant to enter into Trade Options that exceed a Position Limit applicable to the positions underlying its Trade Options. As a result, a commercial participant using one or more Trade Options to meet its physical requirements for a nonfinancial commodity may find itself in violation of that Position Limit with no available exemption for securing the quantity of a nonfinancial commodity required for its commercial business.

For the foregoing reasons, the IECA submits that a commercial participant's position in any Trade Option should not be subject to Position Limits. Similarly, just as confirmation by a commercial participant that it is entering into a swap for purposes of hedging and not speculation can confer pass-through swap status for the benefit of its counterparty, so too should qualification of a transaction as a Trade Option, by virtue of its definitional requirement that at least one counterparty is a commercial participant

entering into a Trade Option solely for purposes related to its business, definitively exclude such Trade Option from position limits for the other counterparty. Context matters, and the Commission should take the fundamental commercial nature of Trade Options into account in its deliberations on position limits.

In addition, there is significant uncertainty as to what is or is not a Trade Option based on the lack of clarity in the CFTC's guidance for distinguishing physical forward transactions from commodity option swaps, and especially the ambiguity of applying the 7-Factor Test. Similarly, there is inconsistency in Form TO reporting of transactions when one party to a trade applies the Commission's test and concludes it is an excluded physical forward and the other party to the same trade applies the Commission's test and concludes it is a Trade Option. These inconsistencies are not surprising when comparing the CFTC's interpretive guidance to the requirements of Section 1a(47)(B)(ii), which says the term "swap" does not include – "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." "Settled" does not mean "delivered." A physically settled contract is settled by an exchange of money for the commodity if the commodity is delivered, or not delivered, as provided in the contract.[6] This is in contrast to a swap, which is "financially" settled by an exchange of cash flows, such as an exchange of a fixed price for a floating price.

Commission rules or staff positions casually including within its regulatory purview transactions that were in fact excluded from that purview by Congress has a substantial potential cost on business, none of which was addressed in the Commission's cost benefit analysis of the Swap Definition Final Rule or its Commodity Option Rule.

We are concerned that a representation believed to be true by a party submitting Form TO may form the basis for prosecution of well-meaning and law-abiding business persons. Section 3 of Form TO contains an Authentication and Consent, whereby an

[6] In its Commodity Option Rule, the Commission took the CEA's exclusion from all of DFA of transactions that are intended to be physically settled and made it an element of being subject to some of DFA. Under Commission Regulation 32.3(a)(3), something is a Commodity Option that can be more lightly regulated as a "Trade Option" subject to Commission regulation if "(3) The commodity option must be intended to be physically settled," However, under CEA §1a(47)(B)(ii) "The term 'swap' does not include any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled". Yet, the Commission in this instance defines "physically settled" as "if exercised, the option would result in the sale of an exempt or agricultural commodity (i.e. non-financial) commodity for immediate (spot) or deferred (forward) shipment or delivery," and adds an element requiring intent of "both parties." Yet "settled" does not mean "purchased" or "sold" or "delivered," and the above phrase added by the Commission to §1a(47)(B)(ii) at 77 F.R. 25326 col. 3 is not in the statute at all. Something that can only be physically settled must be intended to be physically settled, whether or not one or both parties "intend" to "purchase" or "sell" or "deliver." The Commission has added two new elements - "dual intent" to "actually deliver" that are not in the statute. The statute clearly provides that if the parties to a deferred shipment or delivery transaction for a nonfinancial commodity intend to physically "settle" (not "deliver"), then CEA section §1a(47)(B)(ii) trumps CEA §1a(47)(A)(i) and the Commission was not given jurisdiction over such commodity options as "swaps." The Commission has plenary jurisdiction over such commodity options pursuant to CEA §4c and provisions of the CEA pre-dating DFA, but not as "swaps" pursuant to DFA.

individual represents that "that the information and representations [in Form TO] are true and correct." This is certainly not a casual certification exercise given the provisions of the CEA stated below.

Section 6(c)(2) of CEA makes it unlawful to make any false or misleading statement of a material fact to the Commission, including in any … report filed with the Commission under the CEA, or any other information relating to a swap, or a contract of sale of a commodity, in interstate commerce, … or to omit to state in any such statement any material fact that is necessary to make any statement of a material fact made not misleading in any material respect, if the person knew, or reasonably should have known, the statement to be false or misleading.

Section 9(a)(3) of CEA makes it a felony punishable by a fine of not more than $1,000,000 or imprisonment for not more than 10 years, or both, together with the costs of prosecution, for any person knowingly to make, or cause to be made, any statement in any application, report, or document required to be filed under this Act or any rule or regulation thereunder … which statement was false or misleading with respect to any material fact, or knowingly to omit any material fact required to be stated herein or necessary to make the statements therein not misleading.

By the above, the Commission and its Staff are proposing to send to federal prison business people for failing to tell the Commission that the companies they work for engaged in transactions that (a) Congress specifically excluded from being "swaps" under the DFA, and (b) must be deciphered pursuant to characterization rules that are incapable of being interpreted and applied, even by the Commission and its Staff, on a consistent basis.[7]

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[7] Due process of law is also implicated in another way. The Commission published its proposed Commodity Option rules on January 13, 2012 (77 F.R. 2136), before anyone could have known they needed to comment on the rules because the Commission would dramatically expand its jurisdiction to include forward, physically settled transactions with embedded physical optionality in its Swap Definition Final Rule published August 13, 2012. In Footnote 6 of its Commodity Options rule, the Commission says that it "uses the term 'commodity options' to apply solely to commodity options not excluded from the swap definition set forth in CEA section 1a(47)(A), 7 U.S.C. 1a(47)(A)." (77 F.R. 25321; note that the Commission does not refer to CEA 1a(47)(B)(ii)) The Commission then describes the pending final rule defining a "swap," which is being developed jointly with the SEC, and says: "The final rule and interpretations that result from the Product Definitions NPRM will address the determination of whether a commodity option or a transaction with optionality is subject to the swap definition in the first instance. If a commodity option or a transaction with optionality is excluded from the scope of the swap definition, as further defined by the Commission and the SEC, the final rule and/or interim final rule adopted herein are not applicable." (See 77 Fed. Reg. 25321) This means that no one had the ability to comment on the Trade Option rule with any inkling that transactions that are intended to be physically settled would be regulated by the Commission as swaps under DFA and that the Commission would make them subject to its DFA rules by interpreting "physically settled", which is an exclusion from DFA under §1a47(B)(ii), as instead an element of a trade option that would require inclusion within DFA and some DFA compliance. Had the Commission allowed market participants to comment on its rules before promulgating them, it would have learned the difficulties of meeting Commission rules for Trade Options embedded in many types of forward contracts with volumetric optionality.

III. Conclusion.

The IECA appreciates the opportunity to provide the foregoing comments and information to the Commission. This letter represents a submission of the IECA, and does not necessarily represent the opinion of any particular member. If you would like for us to expand our discussion of any of the above-listed discussion points, please let us know.

Yours truly,
INTERNATIONAL ENERGY CREDIT ASSOCIATION

/s/	/s/
Phillip G. Lookadoo, Esq.	Jeremy D. Weinstein
Reed Smith, LLP	Law Offices of Jeremy D. Weinstein