

December 22, 2014

Christopher J. Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Forward Contracts With Embedded Volumetric Optionality, RIN No. 3038-AE24

Dear Secretary Kirkpatrick:

By a Proposed Interpretation published in the Federal Register on November 20, 2014, the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (together, “the Commissions”), jointly issued the CFTC’s proposed clarification of its interpretation concerning forward contracts with embedded volumetric optionality (“Proposed Interpretation”).¹ Specifically, “the CFTC is proposing to clarify its interpretation of when an agreement, contract, or transaction with embedded volumetric optionality would be considered a forward contract.”² The clarification is part of the ongoing effort of the Commissions to complete their regulatory implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).³

By this letter, the Coalition of Physical Energy Companies (“COPE”) responds to the CFTC’s request for comment on the Proposed Interpretation. The members of COPE are physical energy companies in the business of producing, processing, and merchandizing energy commodities at retail and wholesale.⁴ To the degree COPE members engage in forward contracts with embedded optionality, they typically do so to address anticipated volumetric variability driven by

¹ *Forward Contracts With Embedded Volumetric Optionality*, 79 Fed. Reg. 69073 (Nov. 20, 2014).

² *Id.* at 69074.

³ Public Law No. 111-203, 124 Stat. 1376 (2010).

⁴ The members are: Apache Corporation; EP Energy LLC; Iberdrola Renewables, Inc.; Kinder Morgan, Inc.; MarkWest Energy Partners, L.P.; Noble Energy, Inc.; Shell Energy North America (US), L.P.; SouthStar Energy Services LLC; and Targa Resources.

commodity related supply and demand conditions.

COPE Supports the Proposed Changes and Clarifications to the Seven Part Test

COPE welcomes and supports the CFTC's Proposed Interpretation. COPE has filed several comment letters and appeared at the CFTC roundtable on this issue seeking that the CFTC revise or clarify the seven part test in the Products Rule,⁵ as it was overly vague and unworkable. The Proposed Interpretation replaces the previous unworkable test with a meaningful standard supported by an explanatory preamble that will provide physical energy companies the clarity they require to confidently classify their transactions. Further, the Proposed Interpretation evidences a sensitivity to and improved understanding of physical energy companies' businesses and the role of volumetric optionality in contracting on the part of the CFTC.

As noted in the Proposed Interpretation, the most substantive aspect of the proposal is a revision to the seventh element of the test to determine when "an agreement, contract, or transaction with embedded volumetric optionality would be considered a forward contract."⁶ Accordingly, the first six elements are "largely unchanged"⁷ and the seventh element is significantly revised to provide needed clarity and recognize the realities of physical commodities markets.⁸

As proposed, the seventh element will now provide that an agreement will fall within the forward exclusion from the swap definition in the Products Rule when it satisfies the other six elements, and:

7. The embedded volumetric optionality is primarily intended, at the time that the parties enter into the agreement, contract, or transaction, to address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the nonfinancial commodity.⁹

As explained in the Proposed Interpretation,

The seventh element addresses the primary reason for including embedded volumetric optionality in a forward contract. As commenters have explained, commercial parties are often unable to accurately predict their exact delivery needs or production capacity for a given nonfinancial commodity at contract

⁵ *Further Definition of "Swap" ,* "Security-Based Swap," and "Security-Based Swap Agreement"; *Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Fed. Red. 48208 (Aug. 13, 2012) ("Products Rules").

⁶ Proposed Interpretation at 69074.

⁷ *Id.*

⁸ *See id.* at 69074-75.

⁹ *Id.* at 69074.

initiation due to a variety of factors, such as weather and certain other “operational considerations” (e.g., transportation capacity). The embedded volumetric optionality therefore offers commercial parties the flexibility to vary the amount of the nonfinancial commodity delivered during the life of the contract in response to uncertainty in the demand for or supply of the nonfinancial commodity.¹⁰

The Proposed Interpretation also clarifies the following points:

(1) “the focus of the seventh element is intent with respect to the embedded volumetric optionality at the time of contract initiation”;¹¹

(2) “commercial parties ... may rely on counterparty representations with respect to the intended purpose for embedding volumetric optionality in the contract, provided they are unaware, and should not reasonably have been aware, of facts indicating a contrary purpose”;¹²

(3) the fact that “the parties have some influence over factors affecting their demand for or supply of the nonfinancial commodity (e.g., the scheduling of plant maintenance, plans for business expansion) would not be inconsistent with the seventh element of the CFTC’s interpretation, provided that the embedded volumetric optionality is included in the contract at initiation primarily to address potential variability in a party’s supply of or demand for the nonfinancial commodity”¹³; and

(4) “the phrase “physical factors” should be construed broadly to include any fact or circumstance that could reasonably influence supply of or demand for the nonfinancial commodity under the contract.”¹⁴

COPE believes that the combination of the proposed language for the seventh element and the explanatory text clarifying its meaning will serve to provide physical energy companies the clarity they need and permit them to properly classify their relevant physical transactions as forward contracts in keeping with the intent and scope of the Products Rule.¹⁵ The Proposed

¹⁰ *Id.* at 69074-75.

¹¹ *Id.* at 69075.

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ COPE understands that other energy trade associations are advocating that the CFTC remove language in the Proposed interpretation regarding “[c]oncerns that are primarily about price risk” as it is confusing

Interpretation together with its clarifying text recognizes the dynamic nature of energy markets where volumes are often driven by supply and demand conditions and producers, merchandizers, and consumers must make provision therefor in their contracting. Accordingly for the foregoing reasons COPE supports the proposal to revise and clarify the seventh element.

COPE also supports the clarifications to the fourth and fifth elements of the seven part test in the Proposed Interpretation.¹⁶ These clarifications underscore the physical delivery intentions of the parties (buyer and seller) with respect to potential increases or decreases¹⁷ in deliveries at the time the contract is entered into.¹⁸ As such, they are in accordance with the physical nature of these agreements.

Finally, the ambiguity in the application of the seventh factor has caused market participants to devote significant resources in analyzing transactions, together with the associated calculation of notional value, recordkeeping and reporting. These costs fall heavily on companies, like certain of COPE's members, that enter into multiple transactions each day that have some degree of volumetric optionality. The clarification afforded by Proposed Interpretation will materially reduce this burden.

The Propriety of the Interim Final Rule for Commodity Options

In addition to proposing to clarify and improve the seven part test, the Proposed Interpretation seeks comments on whether the Interim Final Rule for Commodity Options ("IFR")¹⁹ properly addresses forwards with embedded optionality.²⁰

COPE welcomes the opportunity to address this unfinished aspect of Dodd-Frank implementation by the CFTC. COPE has consistently made clear that physical contracts, such as

and creates ambiguity. *Id.* at 69075-76. COPE agrees that the Proposed Interpretation would be improved if such language was deleted. However, if the CFTC chooses to retain the language it should apply to all physical end-users as they all share the commercial interest as buyers "to obtain . . . the lowest price" regardless of the physical end-user's regulatory status under state law. *Id.*

¹⁶ *Id.* at 69074, fn. 9.

¹⁷ While COPE understands the volumetric optionality in the fourth and fifth elements refers to increases and decreases in quantity, a limited revision could better express this concept. Thus, the proposed language in those elements could be revised from "deliver /take delivery" to "deliver more or less/ take delivery of more or less", as appropriate.

¹⁸ *Id.*

¹⁹ *See* 77 FR 25320 (April 27, 2012).

²⁰ Proposed Interpretation at 69076.

forwards with embedded optionality, should not be considered swaps under Dodd-Frank.²¹

The confusion and disruption to the physical market by the inclusion of physical contracts as swaps is highlighted by the need for the CFTC to issue the Proposed Interpretation, as well as the convoluted CFTC Office of General Counsel interpretative guidance on infrastructure-related physical contracts²² and the creation of “trade option” status for physical agreements which permit them to be exempted from most swap regulation and be subject to more limited reporting requirements.²³ COPE believes that an over-broad interpretation of the “swap definition” to include purely physical contracts will continue to nag at the CFTC, as it will need to consider whether such contracts will be captured under its proposed rules on position limits,²⁴ a self-evidently absurd outcome. From COPE’s perspective, the CFTC’s overreach in the IFR has only caused problems and increased costs without achieving any legal or public policy purpose.

In several previous comment filings on the Products Rule and the related commodities options rule generally, and the physical contract inclusion issue specifically, COPE has addressed the propriety of defining physical energy contracts as swaps in the context of the IFR.²⁵ COPE also filed comments²⁶ in response to the CFTC’s request for comments on the IFR (which has never been addressed by the agency), in the Products Rule itself.²⁷ An excerpt of COPE’s June 26, 2012 filing is set forth below for your reference (omitting internal footnotes).

The Commission Should Not Define Physically-Settling Commodity Options As Swaps

COPE understands that the Commission may believe that, notwithstanding the physical nature of commodity options that are intended to and can only settle physically, it has limited legal freedom to avoid defining them as “swaps” under Dodd-Frank. COPE believes that not only does the statutory language support not defining physically-settling commodity options as “swap,” but also that doing so would be unproductive in the overall cause of swap regulation and would be harmful to physical energy markets.

²¹ See, e.g., COPE Comments to Products Rule, July 22, 2011 at 2.

²² “Office of General Counsel Response to Frequently Asked Questions Regarding Certain Physical Commercial Agreements for the Supply and Consumption of Energy” (Nov. 14, 2012).

²³ See 17 C.F.R. §32.3 (2014) (Trade Options).

²⁴ See *id.* at § 32.3(c)(2) (providing that “trade options” will be subject to the CFTC’s rules on positions limits).

²⁵ See COPE Comments on Commodity Options and Agricultural Swaps (NOPR), April 4, 2012; COPE Comments on Interim Final Rule (Commodity Options), June 26, 2012).

²⁶ See COPE Comments to Products Rule, July 22, 2011 at 5.

²⁷ See Products Rule at 48239.

The Dodd-Frank Wall Street Reform and Consumer Protection Act⁸ (“Dodd-Frank”) is designed to regulate financially-settling products that can be cleared, exchange traded, used for speculation, or used as hedges (not for physical supply), and take the form of derivative products. The physically-settling commodity options addressed in COPE’s June 7 Letter have none of the characteristics of the products that Dodd-Frank was intended to regulate.

By contrast, commodity options that are intended to and can only settle physically have the following general characteristics:

- Cannot be Cleared: Such options must be physically delivered and are not financially settled. A clearinghouse cannot physically deliver these products.
- Cannot Be Exchange-Traded: As a practical matter, the parties to these options will evaluate their counterparties’ ability to provide them physical products. Only a counterparty capable of physical delivery of the underlying product is even evaluated under other criteria such as creditworthiness. In short, these options are not the kind of fungible product that is susceptible to exchange trading.
- Cannot Be Used For Speculation: Speculators are not interested in physical supply; they are looking for financial settlement. These contracts do not fit the bill. If physical supply were a vehicle for speculation, forward contracts would also be used for that purpose.
- Not Used For Financial Hedging: These physical contracts are only associated with physical delivery. They are not financial risk management tools.
- Not Derivatives: These contracts are physical contracts by nature; unlike swaps, they are not derivatives of physical contracts.

The purpose of Dodd-Frank is to provide a regulatory scheme for the swaps/derivatives market akin to that which exists for the futures markets while also recognizing the continued role of over-the-counter swaps. It is not the purpose of Dodd-Frank to regulate End-Users and their physical transactions. As set forth above and in the June 7 Letter, COPE can discern no regulatory purpose associated with the goals of Dodd-Frank that will be achieved by defining physically-settling commodity options as swaps. The Commission has material discretion in fashioning its rules implementing Dodd-Frank. There are clear legal and factual bases for the Commission to determine that commodity options that are intended to and can only settle physically are not swaps.

Accordingly, COPE respectfully requests that the Commission find that commodity options that are intended to and can only settle physically are not swaps

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COPE is pleased that the CFTC has shown renewed interest in the propriety of the IFR. COPE is hopeful that the agency will revise its interim holding to eliminate physically settling commodity options from the definition of swap. It will thereby avoid the need to continually tweak its regulations to better slide a square peg into a round hole.

Conclusion

COPE welcomes and supports the Proposed Interpretation's clarification of the test for when an agreement, contract, or transaction with embedded volumetric optionality would be considered a forward contract as opposed to a swap. COPE requests that any final issuance provide not only the changes to the elements of the test the CFTC has proposed, but also robust interpretative guidance of the type contained in the Proposed Interpretation.

Further, COPE is heartened by the CFTC's apparent willingness to consider the unfinished business of the IFR and urges that the agency take action to issue a final rule that does not define physically-settling commodity options as swaps.

Respectfully Submitted,

/s/ David M. Perlman

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CC: COPE Members