

Cogen Technologies Linden Venture, L.P. Linden Cogeneration Plant

December 22, 2014

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

Re: *Forward Contracts With Embedded Volumetric Optionality; Proposed Interpretation (RIN 3235-AK65)*

Cogen Technologies Linden Venture, L.P. (“Linden”) is pleased to respond to the request for comment by the Commodity Futures Trading Commission (the “CFTC” or the “Commission”) for its proposed interpretation relating to the evaluation of forward contracts with embedded volumetric optionality (the “Proposed Interpretation”).¹ Linden, an exempt wholesale generator selling electric power at market-based rates under the jurisdiction of the Federal Energy Regulatory Commission (“FERC”), owns and operates a combined cycle natural gas-fired cogeneration facility, located in Linden, New Jersey.²

The electricity produced from Linden’s generator is sold, under a long-term power purchase agreement, to Consolidated Edison Company, which then uses the power to serve the electricity needs of consumers in New York City. Steam from Linden’s operation is sold, also under a long-term contract, to the co-located Bayway Refinery, the largest refinery on the East Coast, for its industrial processes. In both cases, performance by Linden’s cogeneration plant is essential, especially during times of extreme weather.

I. Background

Owners of natural gas-fired cogeneration units, like Linden, require natural gas to operate their facilities in order to produce electricity that will ultimately be distributed to residential, commercial and industrial electricity customers, and steam, which is a critical input to production at industrial facilities. In this regard, they are end users of natural gas and gas transportation services. In many cases, these products are supplied by the units’ local natural gas distribution company. The rates and services that the local natural gas distribution companies are permitted to charge and provide are regulated by the local state public utility commission through State Commission-approved tariffs and agreements.

¹ See Forward Contracts With Embedded Volumetric Optionality, 79 Fed. Reg. 69,073 (Nov. 20, 2014).

² Linden is owned by affiliates of General Electric Company and Highstar Capital.

For example, Linden has entered into a natural gas service agreement (the “Gas Service Agreement”) with its local natural gas distribution companies, Public Service Electric and Gas Company (“PSEG”) and Elizabethtown Gas Company (together with PSEG, the “Gas LDCs”), pursuant to which the Gas LDCs procure sufficient natural gas and gas transportation to allow Linden to operate its cogeneration unit in the ordinary course. In exchange for providing natural gas and gas transportation to Linden, the Gas LDCs are compensated based on a market index.

However, Linden’s agreement with the Gas LDCs, which has been approved by the Board of Public Utilities of New Jersey (the “BPU”), permits the Gas LDCs to interrupt service to Linden in extreme cold-weather³ and, at those times, to instruct Linden to procure replacement natural gas for delivery to the Gas LDCs. This replacement gas is then delivered to the Linden plant by the Gas LDCs for an additional fee. The interruptions in service allow the Gas LDCs to ensure that the natural gas that they procure is at all times sufficient to serve residential customers in New Jersey that require the natural gas for heating purposes.⁴ Whether the Gas LDCs will curtail natural gas to Linden is uncertain as it is dependent on the weather. Accordingly, Linden does not control, and cannot know in advance, whether severe cold conditions will result in many curtailments or whether a mild winter will eliminate curtailments, entirely. Due to the Gas LDCs’ tariff-based commitments to serve residential natural gas demand, the BPU will not allow the Gas LDCs to provide a “firmer” category of natural gas service to Linden.⁵

Electric generating units across the country are faced with similar curtailment issues regarding the supply of natural gas and are forced to look for other alternatives during extreme weather days when their local natural gas distributor(s) may need to curtail service to such generators in order to prioritize the heating needs of residential customers. These electric generating units must have a means to procure natural gas during these curtailment days to meet their contractual obligations. Failure to perform will only serve to inflict a different harm on retail customers—leaving them without electricity during extreme weather and without steam to operate their businesses.

To ensure that sufficient natural gas is available for plant operations when a local natural gas distribution company curtails delivery, electric generating units may enter into contracts to procure natural gas during curtailment periods, which are often referred to as “peaking supply contracts.” The terms of a peaking supply contract enable the electric generating unit to purchase natural gas from another natural gas provider on those days when the local natural gas

³ Pursuant to the terms of the Gas Service Agreement, service may be curtailed on days when the temperature is forecasted to be at or below 22 degrees Fahrenheit as well as under certain other emergency conditions.

⁴ The need for such interruptions stems from the fact that many residences use natural gas, rather than electricity or oil, to heat their homes. During extreme cold-weather days, those residential heaters use more natural gas than is otherwise typical in order to keep the homes at comfortable temperatures. As a result, the Gas LDCs require above-normal amounts of natural gas to serve this demand from residential customers. While this is a problem during extreme cold-weather, the same problem does not exist during extreme warm-weather because most air conditioners run on electricity, not natural gas.

⁵ In other words, in order to ensure that the Gas LDCs have sufficient amounts of natural gas for residential customers to use to heat their homes, the BPU requires generators to secure alternative natural gas supply in cold-weather conditions.

distribution company curtails its natural gas service.⁶ In fact, multiple grid operators on the East Coast (PJM Interconnection, L.L.C. and ISO New England Inc., in particular) have recently proposed strict performance requirements on the electric generating units in their respective service territories, making peaking supply contracts increasingly important as a tool for generators to manage these obligations.⁷

To illustrate this situation, we continue with the Linden example. In 2012, PSEG informed Linden that it could enter into a peaking supply contract with a third-party supplier to ensure that the Linden plant is able to receive natural gas on extreme cold-weather days when the Gas LDCs must curtail service to Linden. Accordingly, in 2013 and 2014, Linden entered into annual peaking supply contracts. Although the natural gas peaking supply contract used by Linden does not limit exercise to curtailment conditions, it was only entered into to cover shortfalls in natural gas supply resulting from the Gas LDCs' tariff-based obligations to serve residential heating customer natural gas demand.⁸

Notably, it is the Gas LDCs, not Linden, that ultimately decides, on days when the forecasted temperature is at or below 22 degrees Fahrenheit, whether Linden will exercise its delivery option under its natural gas peaking supply contract.⁹ Therefore, Linden's natural gas peaking supply contract effectively operates as a "back-up" contract to ensure that Linden can provide: (i) electricity that will ultimately be used to serve New York City residential, commercial and industrial customers, thereby helping to ensure the reliability of the electric power system on the coldest days of the year when electricity demand is high, and (ii) steam to allow the Bayway Refinery to produce refined products, including gasoline, for the East Coast market.

⁶ The peaking supply contracts themselves generally do not reference curtailment; however, as explained below, the end user is practically limited to exercising only during curtailments because they have otherwise contracted through their local distribution company for natural gas and are generally not permitted to re-sell any excess natural gas that is delivered under such agreements.

⁷ *See, e.g.*, PJM Interconnection, L.L.C., Reforms to the Reliability Pricing Market ("RPM") and Related Rules in the PJM Open Access Transmission Tariff and Reliability Assurance Agreement Among Load Serving Entities, FERC Docket No. ER15-623-000 (filed Dec. 12, 2014) (proposing enhanced resource performance requirements to ensure winter peak period reliability and avoid emergency conditions in the future like those experienced during last winter's polar vortex); ISO New England Inc., Filing of Performance Incentives Market Rule Changes, Docket No. ER14-1050-000 (filed Jan. 17, 2014 and approved in pertinent part, by FERC on May 30, 2014) (proposing similar enhanced resource performance requirements).

⁸ The price for obtaining natural gas under Linden's peaking supply contract is based on the market cost of fuel at specified delivery points, plus a specified adder depending on delivery point.

⁹ As described in the Gas Service Agreement, the Gas LDCs call Linden before the start of the gas day and instruct Linden whether or not to schedule natural gas delivery under the peaking supply contract or whether the Gas LDCs will supply Linden's natural gas needs for that upcoming day. The ability of the Gas LDCs to make these decisions, and the ability of Linden to operate its plant using natural gas through its peaking supply contract, has been approved by the BPU.

II. Concerns with the Treatment of Natural Gas Peaking Supply Contracts Under the CFTC’s Seven-Part Test

Linden believes that its natural gas peaking supply contract has no meaningful optionality to Linden. We are concerned, however, that ambiguities surrounding the first two parts of the seven-part test to determine whether a forward contract with embedded volumetric optionality is a “swap”¹⁰ could nonetheless cause some to treat natural gas peaking supply contracts like Linden’s as swaps. In particular, the CFTC explained in its Product Definitions Rule that “[w]here 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.”¹¹ The CFTC further explained that in determining “whether the predominant feature of a transaction is actual delivery, the CFTC will look at the contract as a whole.”¹² We believe that while certain natural gas peaking supply contracts may allow for zero delivery, the facts and circumstances of those contracts, when taken in the context of other arrangements, make clear that the intent for entering into these peaking supply contracts and the predominant feature of such contracts is actual delivery, when needed, of a physical commodity.

The terms of peaking supply contracts entered into by natural gas-fired electric generating unit owners, such as Linden, typically contain an option to specify to the supplier when and if the quantity of natural gas will be delivered on any given day. On days when the electric generating unit is receiving natural gas under its supply contract with a local distribution company, no natural gas will be delivered under the peaking supply contract. And the CFTC has itself noted that peaking supply contracts with embedded volumetric optionality may fall within

¹⁰ The Proposed Interpretation provides the following seven-part test to determine whether a forward contract with embedded volumetric optionality may qualify for the forward contract exclusion:

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;
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 embedded volumetric 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 the embedded volumetric optionality is exercised;
6. Both parties are commercial parties; 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.”

¹¹ Further Definition of “Swap,” “Security-Based Swap,” “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,207, 48,239 (Aug. 13, 2012) (the “Product Definitions Rule”).

¹² *Id.* at 48,239, n.343.

the forward contract exclusion provided they meet the elements of the CFTC’s seven-part test.¹³ However, at least some market participants and regulators have interpreted embedded volumetric optionality that has a “zero-delivery” option to fail the first and/or second parts of the seven-part test.¹⁴ We are concerned that the CFTC may not consider the contextual facts and circumstances surrounding the reasons Linden and other electricity generation owners have for entering into peaking supply contracts with optional delivery, including the “contingent” nature of such gas service contracts from local natural gas distribution companies, and therefore incorrectly construe the option to not exercise delivery under such contract as a determinative factor, thus potentially causing the contract to fail the first and/or second part of the embedded volumetric optionality test.

Commodity Exchange Act (“CEA”) Section 1a(47)(B)(ii) excludes from the definition of “swap” “any sale of a nonfinancial commodity . . . for deferred shipment or delivery, so long as the transaction is intended to be physically settled.”¹⁵ There is nothing in the CEA that limits this exclusion based on the inclusion of volumetric optionality in such contract. The first part of the test in the Proposed Interpretation requires that embedded volumetric optionality “does not undermine the overall nature of the agreement, contract, or transaction as a forward contract.”¹⁶ Similarly, the second part of the test requires that “the predominant feature of [a natural gas peaking supply contract] is actual delivery.”¹⁷

In addition, when discussing the forward contract exclusion in the Product Definitions Rule, the CFTC explained that “contextual factors” may be considered in determining whether a contract qualifies as a forward contract.¹⁸ The Commission should, consistent with its historical approach to evaluating forward contracts, consider the contextual facts and circumstances for determining whether forward contracts with embedded volumetric optionality meet the seven-part test in all circumstances. We believe that the peaking supply contracts entered into by electric generating units, as described above, must be considered in the context of the natural gas service contracts for supply with their local natural gas distribution companies and in the context of the State Commission-approved tariff or other relevant agreements that govern such supply.

When evaluating the intent and overall nature of a natural gas peaking supply contract under the first part of the test, it is essential to view the facts and circumstances surrounding the

¹³ *Id.* at 48,240.

¹⁴ *See id.* at 48,365. (former Commissioner Chilton explained in his dissent that “[c]ontracts that are composed of a forward delivery obligation component combined with an embedded commodity option that can render delivery optional (‘zero-delivery’ embedded volumetric options) are not forwards because the predominant feature of the contract cannot be actual delivery under these circumstances”)

¹⁵ CEA Section 1a(47)(B)(ii), 7 U.S.C. § 1a(47)(B)(ii).

¹⁶ 79 Fed. Reg. at 69,074.

¹⁷ *Id.*

¹⁸ 77 Fed. Reg. at 48,231 (“[T]he CFTC may consider other contextual factors when determining whether a contract qualifies as a forward, such as a demonstrable commercial need for the product, the underlying purpose of the contract (e.g., whether the purpose of the claimed forward was to sell physical commodities, hedge risk, or speculate), the regular practices of the commercial entity with respect to its general commercial business and its forward and swap transactions more specifically, or whether the absence of physical settlement is based on a change in commercial circumstances.”).

contract, including the interruptible supply contract with the local natural gas distribution company, the natural gas peaking supply contract itself, and the particular State Commission-approved tariff or other relevant agreement, to determine the intent of an end user of natural gas, such as Linden, when entering into such a peaking supply contract. In the context of an electric generating unit such as Linden, when a peaking supply contract is entered into as a supplement to a natural gas service agreement with a local natural gas distribution company, the intent of such peaking supply contract is to ensure uninterrupted physical delivery of natural gas. There is no ability for financial settlement of such a contract and natural gas cannot be re-sold by the electric generating unit. The simple fact that there is an ability not to take delivery of the natural gas (i.e., zero delivery) under the peaking supply contract if the natural gas ultimately is not needed, because the local natural gas distribution company does not curtail transmission service to the generating unit, should not render the peaking supply contract a “swap” or a “trade option,” as it is one of several facts that should be considered when viewing the transaction as a whole.

When considering the facts and circumstances surrounding the overall nature of a natural gas peaking supply contract, the Commission should recognize that the embedded volumetric optionality that allows for zero delivery does not undermine the overall nature of the contract, which is to take physical delivery of natural gas to operate an electric generating unit. For example, the State Commission-approved Gas Service Agreement in the case of Linden permits the Gas LDCs to curtail supply to the Linden plant on certain days when the temperature is not forecasted to reach above 22 degrees Fahrenheit, and similarly permits, and effectively encourages, Linden to enter into a natural gas peaking supply contract to cover shortfalls that will result when the Gas LDCs interrupt service on extreme cold-weather days. Because Linden must take natural gas from the Gas LDCs if they supply it, and because Linden cannot re-sell any excess gas it receives under the peaking supply contract, there is no possible motivation for Linden to exercise the option under the peaking supply contract without curtailment of service under the Gas Service Agreement.

Similarly, when determining whether or not “the predominant feature” of the peaking supply contract is “actual delivery” under the second part of the test, it is also essential to consider the contextual facts and circumstances surrounding the contract. The mere fact that the embedded option in a natural gas peaking supply contract may permit “zero-delivery” when the delivery under the contract is not needed (because it is being provided under the “primary” service contract that the electric generating unit has with its local natural gas distribution company), should not cause the contract to fail the second part of the test. Natural gas-fired electric generating units like Linden would not enter into complementary peaking supply contracts but for the need to maintain an uninterrupted supply of natural gas. Accordingly, given the facts and circumstances, the predominant feature of the peaking supply contract is “actual delivery” of natural gas, notwithstanding the fact that the embedded volumetric optionality permits zero delivery. Indeed, there can be no other purpose for entering into the peaking supply contract under these circumstances—if the natural gas is needed due to curtailment from the primary supplier, it will be exercised; if not, the delivery option will not be exercised. As explained, the triggering event is not within the control of the electric generating unit.

Accordingly, we ask the Commission to recognize and make clear that a natural gas peaking supply contract that permits nominal or zero delivery of natural gas may nonetheless

satisfy the seven-part test for embedded volumetric optionality and be eligible for the forward contract exclusion, depending on the facts and circumstances, including the “contextual factors” of why the end user has entered into the peaking supply contract. In particular, we request the Commission note that natural gas peaking supply contracts that permit zero delivery when supply under such contract is not needed because such supply is otherwise being provided under an interruptible contract with a local natural gas distribution company (i.e., the option for delivery under the peaking supply contract is only exercised at times when there is a curtailment by a local natural gas distribution company, as permitted by a state Commission- or FERC-approved tariff or other contract), such peaking supply contract would satisfy the first two parts of the seven-part test. Such clarification would provide much needed certainty for end user electricity generating units such as Linden.

III. Policy Reasons That Certain Natural Gas Peaking Supply Contracts Should Be Eligible for the Forward Contract Exclusion

As discussed above, permitting the peaking supply contracts described herein to qualify for the forward contract exclusion is consistent with the Commission’s historical interpretation surrounding forward contracts and with the text of CEA Section 1a(47); however, there are numerous public policy reasons for the Commission to make clear that certain natural gas peaking supply contracts may be eligible for the forward contract exclusion. Electric generating units, such as Linden, utilize natural gas peaking supply contracts out of necessity to ensure that they receive actual delivery of an uninterrupted supply of natural gas so that they are able to operate their generators. The simplest, most certain way to ensure that electric generating units such as Linden have enough natural gas to keep their plants running during extreme cold-weather conditions is a peaking supply contract.

The Commission should view the contextual factors surrounding the supply of natural gas to an electric generating unit when applying the seven-part test to peaking supply contracts to determine if such contract is eligible for the forward contract exclusion, and should make clear that the ability to receive zero delivery under such peaking supply contracts is not a determinative factor in this analysis. Without clarification from the Commission, peculiar results may occur whereby otherwise identical supply contracts may be treated differently simply because there is an embedded option not to receive delivery under one of those contracts since the physical commodity is only needed when service under an approved agreement is interrupted, without regard to the fact that the intent of the peaking supply contract is to ensure uninterrupted physical delivery of the commodity to the end user.

It should be noted that the weather, which the Commission describes as a “physical factor,” could be the sole reason for the curtailment by the local natural gas distribution company and the reason that the electric generating unit must enter into the peaking supply contract, as is the case with Linden. In other words, extreme temperatures determine when an electric generating unit will need to exercise the option for delivery under the natural gas peaking supply contract. Further, electric generating companies are end users of natural gas that are not speculating. In fact, in most circumstances, they are not permitted to re-sell the natural gas.

Units like Linden are in the business of generating critical products and getting them to their customers. For example, residents of New York City rely on the electricity generated by

Linden to go about their day-to-day lives. The disruption of service from an electric generating unit like Linden during times of extreme weather would add to the difficulty of serving load at critical times.

Finally, subjecting the natural gas peaking supply contracts of electric generating units to treatment as a “swap” or “trade option” would lead to significant operational and administrative burdens, as well as unnecessary costs for such end users of natural gas. We discuss these costs and burdens in more detail in Section IV below.

IV. Treatment as a Swap or Trade Option Is Burdensome, Costly and Unnecessary

Treating such peaking supply contracts as “swaps” would unnecessarily subject electric generating units to a plethora of costly and burdensome requirements, particularly because plant personnel intuitively do not view the contracts as derivative instruments. Such contracts would become subject to all of the Commission’s regulations concerning “swaps,” including, but not limited to, requirements related to reporting, recordkeeping, the posting of margin, position limits and potentially clearing and electronic execution. Most electric generating units are end users of natural gas that do not engage in speculative activities, so subjecting a peaking supply contract to a swap classification would require significant compliance costs for such an entity. Linden, for example, would need to involve supervisory personnel familiar with swap compliance, consider recordkeeping and reporting requirements, and continually monitor rules relating to swaps, which would be a burden, particularly in light of the significant regulatory requirements imposed by FERC and state regulators on their jurisdictional entities.

We appreciate that the CFTC has created a category of swaps called “trade options” that are subject to fewer requirements than swaps; however, we believe that ongoing monitoring and compliance costs, as well as uncertainty surrounding the treatment of such peaking supply contracts as trade options, will nonetheless place significant burdens on end users. Given that certain CFTC rules are not yet final, there remains significant uncertainty on how such swaps or trade options will be treated. For example, rules related to margin for uncleared swaps, clearing requirements for commodity swaps and rules surrounding position limits all remain uncertain. Further, it is unclear what other future impacts the categorization of these transactions in the same manner as financial transactions may have in other contexts and other rule sets.¹⁹

We believe that treatment of the natural gas peaking supply contracts described herein as swaps or trade options would unnecessarily increase compliance burdens that would increase costs for electric generating units to produce electricity without concomitant benefit.

V. Conclusion

We thank the CFTC for providing us an opportunity to comment on the Proposed Interpretation. Linden appreciates the Commission’s work to protect end users of derivatives and consider the costs and burdens that certain regulations may impose on such end users.

¹⁹ For example, other government agencies may cross-reference “swaps” or “trade options” in their rules or guidance.

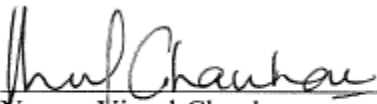
Thank you for your consideration of this very important issue for electric generating units. Please contact Amy Fisher, Managing Director, Regulatory Affairs at GE Energy Financial Services, Inc. at (203) 357-4417 or amy.fisher@ge.com or the undersigned at (203) 961-5223 or vimal.chauhan@ge.com if you have any questions or concerns.

Sincerely,

COGEN TECHNOLOGIES LINDEN VENTURE, L.P.

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