600 North 18th Street / GS 8259
Birmingham, AL 35203

December 22, 2014

<u>Via Electronic Submission</u>
Chris Kirkpatrick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Proposed Interpretation regarding Forward Contracts with Embedded Volumetric Optionality (RIN Number 3038-AE24)

Dear Mr. Kirkpatrick:

Southern Company Services, Inc., acting on behalf of and as agent for Alabama Power Company, Georgia Power Company, Gulf Power Company, Mississippi Power Company, and Southern Power Company (collectively, "Southern"), hereby submits Southern's comments in response to the Commodity Futures Trading Commission's ("Commission") request for public comment related to the above-referenced Proposed Interpretation.[1]

I. Introduction.

Southern includes four regulated retail electric service providers, each regulated by the public service commission ("PSC") in its respective state, as well as by the Federal Energy Regulatory Commission ("FERC"). Southern buys and sells in the wholesale electric power markets, pursuant to market-based rate authority granted by FERC. This authority requires Southern to transact in energy at "just and reasonable" prices regulated under the Federal Power Act. Southern provides service to retail electric customers at rates that are regulated by the respective PSCs. Southern Power Company operates a competitive generation business (also regulated by FERC) that helps meet the needs of municipalities, electric cooperatives and investor-owned utilities. Southern seeks to provide excellent service to their customers at stable prices.

The following comments discuss how the Proposed Interpretation will impact Southern and its customers.

[1] *See Proposed Interpretation, Forward Contracts with Embedded Volumetric Optionality*, 79 Fed. Reg. 69073(November 13, 2014)("Proposed Interpretation").

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

Mr. Paul Hughes
Manager, Risk Control
Southern Company Services, Inc.
600 North 18th Street / GS 8259
Birmingham, AL 35203
email: phughes@southernco.com
Phone: (205) 257-3035
Fax: (205) 257-5858

K.C. Hairston, Esq.
Balch & Bingham LLP
1710 6th Ave. North
Birmingham, AL 35223
Email: kchairston@balch.com
Phone: (205) 226-3435
Fax: (205) 488-5862

II. <u>Comments on the Proposed Interpretation</u>.

Southern greatly appreciates the Commission's actions to better clarify when transactions that contain embedded volumetric optionality should be considered excluded forward contracts. Southern has experienced firsthand many of the difficulties the Proposed Interpretation describes related to implementing the existing seven-part test and shares in the industry's general reluctance to rely upon the exclusion it offers. As the Commission is aware, the current seventh element contains language which is subject to a wide range of interpretations, and second guessing, that has made it difficult (if not impossible) to incorporate into contracts. Based on these concerns, Southern views the Commission's Proposed Interpretation as an important step in the right direction and commends the Commission and Staff on their efforts to better understand the energy industry and to offer these much needed clarifications. To further the Commission's efforts in this regard, Southern offers the following comments.

1. <u>Clarifications to Fourth and Fifth Elements</u>.

Southern generally supports the Commission's clarifications regarding the fourth and fifth elements. We believe that these proposed changes, which clarify that the Commission's interpretation applies to embedded volumetric optionality in the form of both puts and calls, is a technical correction and will permit the industry to apply these elements as the Commission originally intended.

2. <u>Impact of Acting on Concerns about Price Risk vs. Concerns Primarily about Price Risk</u>

In the Proposed Interpretation the Commission states:

> Concerns that are <u>*primarily*</u> about price risk (*e.g.*, expectations that the cash market price will increase or decrease), however, <u>*would not satisfy the seventh element*</u> absent an applicable regulatory requirement to obtain or provide the lowest price (*e.g.*, the buyer is an energy company regulated on a cost-of-service basis).

(emphasis added)(79 Fed. Reg. at 69075-69076). Elsewhere in the Proposed Interpretation, the Commission states:

> For example, in choosing whether to obtain additional supply by exercising the embedded volumetric optionality under a given contract or turning to another supply source— whether storage, the spot market, or another forward contract with embedded volumetric optionality—*commercial parties would be able to consider a variety of factors, including price,* provided that the intended purpose for including the embedded volumetric optionality in the contract at contract initiation was to address physical factors or regulatory requirements influencing the demand for or supply of the commodity.

(emphasis added)(79 Fed. Reg. at 69075 n.18). As highlighted in the above two quotes from the Proposed Interpretation, concerns "primarily about price risk" can cause the parties to fail the seventh element, while "considering a variety of factors, including price" is permitted by the Commission. Southern is concerned that when the industry begins to implement the new interpretation, the "primarily about price risk" language will be plagued with the same issues as the "outside the control of the parties" language. At what point does Southern's concern about "price risk" become a concern "primarily about price risk"? As the Commission is aware, parties execute contracts with one another to obtain more certainty. However, including representations about what is "outside the control of the parties" or that the parties' concerns are not "primarily about price risk" requires the parties to represent to each other an unknown and vague standard. In other words, Southern believes that removing the "outside the control of the parties," but adding the "primarily about price risk" will be swapping one vague standard for another. The Commission noted in the Proposed Interpretation that the "outside the control of the parties" language has "apparently created problems during contract negotiations, as counterparties often disagree about the degree of control they have over factors influencing their demand for or supply of the nonfinancial commodity." (79 Fed. Reg. at 69075). Southern believes there will be similar problems as parties attempt to contract around when a concern relates to price risk versus "primarily" relates to price risk – and such subtle distinction dictates whether the seventh element is failed. Therefore, Southern respectfully requests that the Commission delete the text in the first block quote above, thereby removing the "primarily about price risk" standard when it issues the Final Interpretation. Southern believes that the proposed seventh element along with Footnote 18 provides the necessary guidance to achieve the Commission's intended outcome for additional clarity.

3. Contracts that are Intended to Be Physically Settled Should Not Be Subject to the Seven-Part Test

In the preamble to the Proposed Interpretation, the Commission states:

> In providing its interpretation, the CFTC was guided by and sought to reconcile agency precedent regarding forward contracts containing embedded optionality with *the statutory definition of "swap" in section 1a(47) of the CEA, which provides, among other things, that commodity options are swaps, even if physically settled.*

(emphasis added)(79 Fed. Reg. at 69074). However, Southern respectfully represents that this is not what section 1a(47) provides. The only reference to "physically settled" products in section

1a(47) is where such products are specifically excluded from the definition of a "swap." In this regard, the United States Congress specifically amended the Commodity Exchange Act to state that "[t]he 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." The plain reading of the statute cannot be reconciled with the Commission's statement that "*the statutory definition of 'swap' in section 1a(47) of the CEA*, which *provides*, among other things, that *commodity options are swaps, even if physically settled*." Southern requests that the Commission begin its "further definition" of section 1a(47) in a manner that the statutory exclusions apply – and therefore such statutorily excluded contracts are not subject to the seven-part test.

4. The Commission Should Exclude Contracts that Qualify as Normal Purchases Normal Sales Under the Accounting Standards (Officially Recognized by the SEC) From the Swap Definition (so that the accounting treatment matches the Dodd-Frank classification)

Southern believes that it is important that the classification of transactions as "swaps" for Dodd-Frank compliance be consistent with the classification of derivatives as set forth in Generally Accepted Accounting Principles ("GAAP"). The Financial Accounting Standards Board ("FASB"),[2] as a designated organization of the SEC, has longstanding guidance in regards to what transactions should be accounted for as derivatives under Accounting Standards Codification ("ASC") 815 (formerly referred to as "FAS 133"). In this regard, parallel to the processes Southern has implemented to classify transactions for Dodd-Frank compliance purposes (as prescribed by the CFTC) is Southern's existing processes for reviewing transactions for derivative accounting treatment (as officially recognized by the SEC). Southern's accounting processes are routinely audited and monitored by the applicable regulators. Having two separate processes conducting effectively the same types of determinations is unnecessary, potentially wasteful and can lead to confusion and inconsistencies across a company's records. This duplication could be eliminated or minimized if the CFTC would permit transactions that are excluded from derivatives accounting treatment to be excluded under the CFTC's definition of a swap. The CFTC has taken a similar approach in Rule 1.3 (kkk), where the Commission included transactions in its definition of "hedging or mitigating commercial risk" that qualify for hedging treatment under ASC 815.

Although not all companies use ASC 815, companies that do (and therefore would have the duplicative contract classification reviews being conducted) could rely on this new exclusion if adopted by the Commission. This would allow for more consistency between the CFTC and SEC, thereby preventing products that are classified as swaps (or not classified as swaps) from being treated differently for accounting purposes – an outcome Southern believes is meaningful and important. It is noteworthy that the accounting standards have already addressed many of

[2] Since 1973, FASB has been the designated organization in the private sector for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. Those standards are officially recognized as authoritative by the Securities and Exchange Commission ("SEC") (Financial Reporting Release No. 1, Section 101, and reaffirmed in its April 2003 Policy Statement) and the American Institute of Certified Public Accountants (Rule 203, Rules of Professional Conduct, as amended May 1973 and May 1979).

the issues in which the Commission is currently engaged, such as the uniqueness of various energy related contracts and Southern encourages the Commission to review these as part of its assessment of these comments.[3]

As further background, ASC 815 sets forth the accounting requirements for derivative instruments and hedging activities. Under ASC 815, contracts that qualify as "Normal Purchases Normal Sales" generally do not have to be accounted for as derivative instruments. Thus, to achieve consistency between the Dodd-Frank classification and the accounting classification, contracts excluded by the Normal Purchases Normal Sales exclusion should be similarly excluded from the definition of a "swap" under Dodd-Frank. As demonstrated below, the CFTC's view of the types of contracts that should be excluded from the definition of a "swap" in the Proposed Interpretation *is shockingly similar* to the contracts that are excluded under GAAP for derivatives accounting.

CFTC (Proposed Interpretation)	ASC 815 (Existing Accounting Standards)
"The predominant feature of the agreement, contract, or transaction is actual delivery." 79 Fed. Reg. at 69074 (Second Element). "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." 79 Fed. Reg. at 69074 (Fourth Element). "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." 79 Fed. Reg. at 69074 (Fifth Element). "Both parties are commercial parties." 79 Fed. Reg. at 69074 (Sixth Element).	According to the definition provided in FAS 133, "Normal Purchases Normal Sales" are products that "provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business." (*See* ASC 815-10-15-22). "To qualify for the normal purchases and normal sales scope exception, it must be probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery." (*See* ASC 815-10-15-35)
"By removing this language, the CFTC intends to clarify that the focus of the seventh element is intent with respect to the embedded volumetric optionality at the time of contract	The assessment of whether a transaction qualifies for the normal purchase normal sale shall be performed only at the inception of the contract (*See* ASC 815-10-15-23).

[3] *See*, for example, ASC 815-10-15-48.

initiation." 79 Fed. Reg. at 69075.	
"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." 79 Fed. Reg. at 69074 (Seventh Element).	To qualify for the exception, "a contract's terms must be consistent with the terms of an entity's normal purchases or normal sales, that is, the quantity purchased or sold must be reasonable in relation to the entity's business needs. Determining whether or not the terms are consistent requires judgment." (*See* ASC 815-10-15-27).
"This language was included to embody the longstanding principle, recognized by commenters, that intent may be ascertained by the relevant facts and circumstances surrounding the contract, including the parties' course of performance thereunder." 79 Fed. Reg. at 69075.	In making this determination, an entity should consider all relevant factors, including all of the following: a. The quantities provided under the contract and the entity's need for the related assets b. The locations to which delivery of the items will be made c. The period of time between entering into the contract and delivery d. The entity's prior practices with regard to such contracts. (*See* ASC 815-10-15-28)
"This language was included to embody the longstanding principle, recognized by commenters, that intent may be ascertained by the relevant facts and circumstances surrounding the contract, including the parties' course of performance thereunder." 79 Fed. Reg. at 69075.	Further, each of the following types of evidence should help in identifying contracts that qualify as normal purchases or normal sales: a. Past trends b. Expected future demand c. Other contracts for delivery of similar items d. An entity's and industry's customs for acquiring and storing the related commodities e. An entity's operating locations. (*See* ASC 815-10-15-29)

Based on the foregoing similarities between the types of products intended to be excluded under the CFTC's Proposed Interpretation and the existing accounting standards officially recognized by the SEC, and the desire of the Commission to reduce unnecessary duplication and burdens, Southern respectfully requests that the Commission adopt a presumption that contracts that are excluded from derivative accounting under the Normal Purchases Normal Sales exclusion, similarly be excluded from the definition of a swap under the Commission's regulations.

5. Responses to the Commission's Enumerated Questions

A. "The CFTC invites comment on whether the IFR's approach to defining the universe of swaps subject to its exemption may provide a clearer and easier mechanism for providing relief from swaps requirements than the CFTC's interpretation of forwards with embedded volumetric optionality and whether the IFR currently provides sufficient relief for such contracts."

Southern believes that the best approach is to issue a Final Interpretation so that contracts that are intended to be excluded by Congress and the Commission are not subject to the Trade Option requirements. The Commodity Option IFR does provide limited relief, but such transactions are still subject to costly reporting and recordkeeping rules. Moreover, Southern believes it is worth noting that such relief will be significantly reduced if Trade Options remain subject to Position Limits.

Southern believes that the compliance burden for Trade Options has been significantly underestimated by the Commission. In this regard, the Commission has estimated that it takes approximately 2 hours *per year* to complete a Form TO. Several trade associations for the energy industry provided comments to the Commission that the burden estimate was grossly understated. The Commission summarized these concerns to the United States Office of Management and Budget as follows:

> Two commenters, however, specifically opined on the Form TO information collection, stating that both the Commission's estimate of annual number of respondents to Form TO and burden hours to complete Form TO were understated. The American Power Association, National Rural Electric Cooperative Association, Edison Electric Institute, and Electric Power Supply Association, writing together ("Joint Electric Associations"), noted that there are over 3,000 electric utilities in the United States, most of whom use trade options, and even more non-utility market participants in the electric industry that may use trade options. The International Energy Credit Association ("IECA") noted that there could be hundreds of respondents in the energy industry alone submitting Form TO annually. As for the Commission's burden hour estimate, the Joint Electric Associations believed two hours to be "unreasonably low," noting that "most potential filers of Form TO will be unlikely to have staff familiar with the Commission and its new jurisdiction over swaps," which will require such filers "to review the relevant provisions of the Commodity Exchange Act and the Commission's rules, amend relevant trade option documentation to validate that the commodity options meet the conditions in Rule 32.3, and keep track of which trade options are unreported." IECA estimated that it would take "much longer than two hours" to capture all unreported trade options for a year, particularly when separating unreported trade options entered into with non-SDs/MSPs from reported trade options entered into with SDs/MSPs.

Despite these concerns and revised burden estimates, the Commission represented to the United States Office of Management and Budget the following position:

> The Commission disagrees, however, with the view as expressed by commenters that it would take much longer than two hours each year to prepare and submit Form TO. The Commission ***does not believe*** that an intricate knowledge of the Commodity Exchange Act or the agency's procedures, personnel, and implementing regulations ***is necessary in order to accurately prepare and submit a Form TO*** in approximately two hours to the Commission, as required under Regulation 32.3(b)(2) and explained in the instructions attached to the document.

See CFTC Supporting Statement to United States Office of Management and Budget, http://www.reginfo.gov/public/do/DownloadDocument?documentID=389106&version=1 (April 8, 2013)(emphasis added). Southern believes the CFTC's estimate is grossly misleading and severely understated. As provided in the estimate below, Southern represents that the burden to comply with the Trade Option requirements is much greater.

B. "Market participants have argued that the lack of clarity around the seventh element of the CFTC's interpretation has led to costs to end-users. Conceivably, since contracts that fail one or more of the seven elements would be regulated as exempt commodity trade options under the IFR, these costs are attributable to complying with the IFR. The CFTC invites comment on whether or not this is the case, and invites the submission of data quantifying those costs."

Southern agrees. A primary factor in determining the burden of complying with the Trade Option rules relates to the number of contracts that are subject to the requirements (*e.g.*, not excluded under the seven-part test, etc.). In this regard, after a contract is determined to be a Trade Option, certain document retention requirements must be instituted and the contract has to be reviewed and monitored for Form TO and No-Action reporting. For example, the optionality must be identified and valued to complete the Form TO. On average, the estimated cost for Southern to review a Trade Option for the Form TO can range from approximately $100 - $400 per contract. The chart below provides the details for this estimate and compares the estimate to the data the CFTC provided to the United States Office of Management and Budget:

Comparison of Southern's and CFTC's Estimates to Complete Form TO		
	Southern	**CFTC**
Typical number of employees involved in reviewing/analyzing contract	2	1
Estimated average hours per employee	.5 hours to 2 hours *per contract* depending on the length and complexity of each contract.	2 hours per year

Employee labor rate	$100 per hour[4]	$100 per hour
Legal review allocated across similar types of contracts. (Not all contracts require legal review)	$50 - $300 per contract, depending on the length and complexity of each contract.	$0
Estimated Average Total Costs (Not including legal costs)	**$100 - $400 per contract**	**$200 per year**

Note: Southern invested over $80,000 to develop software to assist personnel with the evaluation of contracts for Dodd-Frank purposes. Without this software in place, the estimated burden figures would be significantly higher.

Accordingly, the higher the number of contracts that are subject to the Trade Option rules, the higher the costs will be that are attributable to Trade Option compliance. For example, for the 2013 Form TO (which only covered approximately nine months), Southern reported approximately 60 Trade Options at an estimated Form TO compliance burden cost of $12,000 per year (assuming $200 per contract on average). These estimates do not include on-going costs for training, technology, record-keeping or the additional "transaction/negotiation costs" which were incurred related to Trade Option classification. Southern's estimate of $12,000 for the annual cost to prepare a Form TO is much higher than the $200 per year estimated by the Commission.

Southern believes that if the Proposed Interpretation, as clarified herein, were applied to the same set of contracts, a majority of the contracts would not have needed to be reported on the Form TO – resulting in a significant reduction of the compliance burden estimated above. As discussed herein, Southern believes that the best approach is to issue a Final Interpretation so that contracts that were specifically intended to be excluded by Congress are not subject to the Trade Option requirements.

C. What factors should the CFTC consider in determining whether the proposed modifications and clarifications to the CFTC's interpretation are appropriate in view of CFTC precedent regarding the interpretation of the CEA's forward contract exclusion?

As discussed herein, the Commission's further definition of the term "swap" should recognize that Congress specifically excluded contracts that are intended to be physically settled. In addition, the Commission should consider the benefits of having consistencies between the Dodd-Frank regulations and the existing accounting standards for derivatives (which are officially recognized by the SEC).

D. Do the proposed changes provide sufficient clarity on how contracts with embedded volumetric optionality may satisfy all seven elements of the interpretation, particularly the first and second elements?

[4] $100/hour rate used by the CFTC in the OMB filing.

Yes, based on the clarifications requested herein.

E. Are there reasons why trying to provide further relief through the swap definition's forward contract exclusion would not be in the public interest?

No. Southern believes it is in the public interest to do so and such clarifications will benefit the reliability of the electric system and reduce compliance costs that are ultimately borne by its wholesale and retail customers. Furthermore, Southern believes it would be in the public interest for the CFTC to consider exempting all regulated FERC jurisdictional products from the Dodd-Frank swap definition because: (a) regulated utilities were not involved in the 2008 economic crisis and represent little, if any, risk to the financial markets; (b) regulated utilities serve a unique service to their customers that is already stringently regulated on a federal level (and in some instances on a state level); (c) the limited benefits of imposing Dodd-Frank regulations compared to the on-going burden of compliance; (d) electricity contracts are different from the traditional CFTC regulated financial products, and therefore should be regulated differently; and (e) the Commission has already exempted the RTO/ISO transactions, which represent a large portion of the wholesale energy market.

III. Conclusion.

Southern appreciates the opportunity to provide the foregoing comments and information to the Commission. Please contact us as indicated above if you would like to discuss these comments.

Yours truly,

Southern Company Services, Inc.

By: /s/ Paul Hughes
Title: Manager, Risk Control