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


June 22, 2015

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

***Re: Trade Options; Notice of Proposed Rulemaking (RIN 3038-AE26)***

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 notice of proposed rulemaking relating to trade options (the "Proposed Rule").[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.

Linden filed a comment letter to the Commission on December 22, 2014[3] on the Commission's proposed interpretation relating to forward contracts with embedded volumetric optionality[4] in which we discussed why, among other things, the peaking supply contracts that Linden enters into to be assured of adequate natural gas supply when its primary supply source has curtailed delivery pursuant to regulatory requirements to prioritize residential customers, are not swaps or commodity options. We appreciate the CFTC's efforts to clarify the status of certain supply contracts in its final interpretation relating to forward contracts with embedded volumetric optionality;[5] however, despite the clarifications in the final interpretation, we believe that there still remains uncertainty with respect to the treatment of peaking supply contracts like

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1 *See* Proposed Rule, Trade Options, 80 Fed. Reg. 26,200 (May 7, 2015).

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

3 *See* Comment Letter from Cogen Technologies Linden Venture L.P., Comment No. 60092 (Dec. 22, 2014) ("Initial Comment Letter"), available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=60092&SearchText=.

4 *See* Proposed Interpretation, Forward Contracts With Embedded Volumetric Optionality, 79 Fed. Reg. 69,073 (Nov. 20, 2014).

5 *See* Final Interpretation, Forward Contracts With Embedded Volumetric Optionality, 80 Fed. Reg. 28,239 (May 18, 2015).

those used by Linden. We are pleased that Commissioner Bowen has recognized in her concurrence to the Proposed Rule the challenges that the uncertainty around the treatment of such peaking supply contracts continues to cause for electric generating units such as Linden.[6] As discussed below, Linden is supportive of Commissioner Bowen's proposed criteria to help determine whether or not peaking supply contracts used when primary supply is unavailable are commodity options and we request that the Commission clarify in its final trade options rule that such peaking supply contracts are commercial agreements that are not commodity options.

Linden notes that, as mentioned in our Initial Comment Letter, this question has taken on additional urgency because several of the independent system operators conducting organized electricity markets under the jurisdiction of FERC have required power generators located in their respective service territories to be able to show that they can obtain natural gas under all operating conditions, even when their primary suppliers, local natural gas distribution companies, are permitted by their state regulators to curtail deliveries under certain weather conditions. Peaking gas contracts are an obvious tool to help address this conundrum.[7]

## 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.

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

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[6] *See* 80 Fed. Reg. at 26,209-10.

[7] *See* 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); PJM Interconnection, L.L.C., Revisions to the Reliability Pricing Market and Related Rules in the PJM Open Access Transmission Tariff and Reliability Assurance Agreement Among Load Serving Entities, Docket No. ER15-623 (filed December 12, 2014 and approved in pertinent part by FERC on June 9, 2015); and PJM Interconnection, L.L.C., Docket No. EL15-29-000 (filed December 12, 2014 and approved in pertinent part by FERC on June 9, 2015).

to Linden in extreme-cold weather[8] 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.[9] Whether the Gas LDCs will curtail natural gas to Linden is uncertain as it is dependent on the weather and other matters outside of Linden's discretion. 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.[10]

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 distribution company curtails its natural gas service.[11] In fact, as stated above, multiple grid operators on the East Coast have recently established strict performance requirements and imposed significant penalties 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.

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[8] 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.

[9] 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.

[10] 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.

[11] 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.

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, by its terms, 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.[12]

Notably, it is the Gas LDCs, not Linden, that ultimately decide, 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.[13] 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.

## II. Concerns with the Treatment of Natural Gas Peaking Supply Contracts As Commodity Options

We believe that natural gas peaking supply contracts such as Linden's are commercial agreements similar to those described in the preamble to the CFTC's final rule further defining the term "swap"[14] and therefore such transactions do not constitute commodity options (and therefore would not be trade options). We are concerned, however, that ambiguities surrounding the Proposed Rule and the seven-prong test to determine whether a forward contract with embedded volumetric optionality is a "commodity option"[15] could nonetheless cause some to treat natural gas peaking supply contracts like Linden's as commodity options which do not meet the test because the option may never be exercised. We believe the Commission's clarification that peaking supply contracts that meet the narrowly tailored criteria proposed in Commissioner Bowen's concurrence to the Proposed Rule are not commodity options would go a long way in providing certainty to end users, thereby reducing the compliance and operational burdens of electric generating units such as Linden.

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[12] 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.

[13] 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.

[14] *See* Final Rule, Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps, Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,208, 48,246-50 (Aug. 13, 2012).

[15] *See* 80 Fed. Reg. 28239. Commodity options would be considered "swaps" based on the definition in Commodity Exchange Act Section 1a(47).

Treating such peaking supply contracts as "commodity options" would unnecessarily subject electric generating units to a plethora of costly and burdensome requirements, taking commercial arrangements and categorizing them as derivative instruments, which in many businesses enmeshes them in a higher degree of compliance oversight, internal reporting and risk mitigation analysis. In addition, 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. We appreciate that the CFTC has created a category of swaps called "trade options" and that the Proposed Rule creates fewer requirements than swaps and other commodity options; 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 and result in unnecessary monitoring as contract parties err on the side of conservatism. Given that certain CFTC rules are not yet final, there remains uncertainty as to how such commodity options or trade options will be treated. For example, rules relating to position limits and the treatment of trade options under such rules 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 regulatory contexts and other rule sets.

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, commodity option or trade option classification requires significant compliance costs for such an entity. Linden, for example, would be required to consult with supervisory personnel familiar with swap compliance and outside legal counsel, consider recordkeeping and reporting requirements, consider the categorization of such transactions and continually monitor rules relating to swaps, commodity options and trade options, which would be a burden, particularly in light of the significant regulatory requirements imposed by FERC and state regulators on their jurisdictional entities.

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

## III. The Commission Should Clarify That Certain Peaking Supply Contracts Are Not Commodity Options

We ask the Commission to make clear in the final trade options rule that natural gas peaking supply contracts should not be considered commodity options, as such contracts are customary business arrangements between commercial entities (i.e., the natural gas supplier and the electric generating unit). Such a conclusion is consistent with and would provide further clarity to the Commission's discussion of "commercial agreements" in the Final Product Definitions Rule. In that rule, the CFTC explained that "commercial agreements" that involve customary business arrangements may not be considered "swaps" depending on the facts and

circumstances.[16] The Commission explained further that such an interpretation "should allow commercial and non-profit entities to continue to operate their businesses and operations without significant disruption . . . ."[17] While this discussion of commercial agreements is encouraging, it remains unclear how peaking supply contracts, such as those entered into by Linden and described in this comment letter, would be treated, and, in particular, whether they would be considered as forward contracts with embedded volumetric optionality subject to the seven-prong test.[18] The uncertainty surrounding the treatment of such peaking supply contracts may have a chilling effect on the way that electric generating units operate their business and adds a level of operational complexity that is costly and unnecessary.

We believe the criteria proposed in Commissioner Bowen's concurring statement to the Proposed Rule would provide certainty to end users that certain peaking supply contracts that meet a specified set of criteria are not commodity options. The Commission should explain in its final rule regarding trade options that commercial agreements that meet these factors are not commodity options. This clarification would eliminate concerns and provide certainty when end-user electric generating units such as Linden use such arrangements to help ensure the reliability of the electric power system.

While we have described Linden's peaking supply contracts in detail in Section I above, we have provided below a brief analysis of a typical Linden peaking supply contract under Commissioner Bowen's proposed criteria.[19]

> A. *The subject of the agreement, contract or transaction is a binding, sole-source, obligation of a supplier of a physical commodity to stand ready to meet a specified portion of a commercial consumer's physical need for a commodity through providing for the physical delivery of that commodity to the specified commercial consumer or its designee in connection with the physical obligation.*
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> A typical peaking supply contract with the natural gas supplier would be a binding transaction for which the natural gas supplier is the "sole-source" of delivery of such natural gas in the event that the Gas LDC has curtailed delivery. Until such time, the natural gas supplier would be "standing ready" to meet the demand of Linden's physical need for natural gas when called upon to do so.
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> B. *The payment provided by the commercial consumer to the commercial supplier for such agreement, contract or transaction is in the nature of a reservation charge to*

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[16] *See* Final Rule, Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,206, 48,247-48 (Aug. 13, 2012).

[17] *Id.* at 48,247.

[18] As we discussed in our Initial Comment Letter, the treatment of such peaking supply contracts under the seven-prong test remains uncertain. In particular, the Commission's final interpretation relating to embedded volumetric optionality does not address concerns as to whether such peaking supply contracts qualify under the second prong of the seven-prong test.

[19] *See* 80 Fed. Reg. at 26,210.

*provide the service of standing ready to meet the physical needs of the commercial consumer.*

Any fees paid by Linden to the natural gas supplier under a typical peaking supply contract would be for the natural gas supplier to "stand ready" to meet Linden's needs for physical natural gas.

C. *Payment for any commodity delivered under such agreement, contract or transactions is at the market price for that commodity at the time of delivery (i.e., the agreement, contract or transaction is not used to hedge price risk).*

The natural gas delivered under Linden's typical peaking supply contract would be priced at the market price at the time of delivery.

D. *The agreement, contract or transaction is necessary to meet the commercial consumer's projected physical needs or is required by regulation.*

It is essential that Linden have this type of peaking supply contract in place so that it can meet its need for natural gas so that it can generate electricity during extreme-weather days. The Gas LDCs have tariff-based commitments to serve residential natural gas demand, which allows them to curtail service to Linden during extreme cold. As a result, the BPU requires that Linden secure an alternative natural gas supply during extreme cold conditions. The peaking supply contract is a permitted method Linden has used for obtaining such alternative natural gas supply. Further, Linden's production of electricity to New York City is essential for ensuring the reliability of the electric power system.

After analyzing the peaking supply contract using the criteria above, it is clear that such contract is a commercial end-user agreement with essentially no optionality, as the alternative supply must be secured for the electric generating unit to continue to operate and is required by tariff/regulation. Accordingly, we request that the Commission clarify that such peaking supply contracts are not "commodity options" or "trade options."

## IV. Policy Reasons That Certain Natural Gas Peaking Supply Contracts Should Not Be Considered Commodity Options or Trade Options

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 consider the contextual factors surrounding the supply of natural gas to an electric generating unit when determining whether such a contract is a commercial agreement that is outside the scope of the Commission's regulation and make clear that peaking supply contracts such as those that meet the criteria set forth in Commissioner Bowen's concurring statement are not commodity options or trade options.

Linden is aware that the Commission has declined to address the status of these supply contracts in the context of the forward contract exclusion under Commodity Exchange Act Section 1a(47). However, the final trade options rule is an appropriate vehicle for the Commission to address the issue and provide certainty to market participants. Without the clarification requested in this letter, peculiar results may occur whereby otherwise identical supply contracts may be treated by some counterparties differently simply because of perceived optionality not to receive delivery under one of those contracts since the physical commodity is only needed when service under an approved agreement is interrupted. Such an anomalous result would not recognize that the intent of the peaking supply contract is to ensure uninterrupted physical delivery of the commodity to the end user and there are regulatory and tariff requirements to maintain uninterrupted service.

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. In addition, under the new independent system operator "pay-for-performance" requirements, a generating unit would be severely penalized[20] for not having addressed its natural gas curtailment risk, making this clarification increasingly important to end users.

Finally, subjecting the natural gas peaking supply contracts of electric generating units to treatment as a "commodity option" or "trade option" would lead to significant operational and administrative burdens, as well as unnecessary costs for such end users of natural gas without any discernable benefit.

## V. Conclusion

We thank the CFTC for providing us an opportunity to comment on the Proposed Rule. 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.

[20] A primary consideration in enacting pay-for-performance mechanisms, which can penalize a generation unit at a rate of 150% of the payments it earns in the capacity markets, is to compel the unit to be certain it has firm natural gas supply. As explained by FERC in its recent order approving the PJM Capacity Performance tariff revisions, "The Commission has been actively involved in the review of capacity markets and larger trends regarding resource adequacy and fuel assurance. In particular, the commission directed regional transmission organizations (RTOs) and independent system operators (ISOs) to file reports on the status of their efforts to address fuel assurance issues . . . . PJM states that its proposed reforms were prepared in the context of these related policy initiatives, and are designed to ensure that resources committed as capacity to meet PJM's reliability needs will deliver the promised energy and reserves when called upon in emergencies, and thus will provide the reliability that the region expects and requires." Order on Proposed Tariff Revisions in Docket Nos. ER15-623-000 and EL15-29-000 (June 9, 2015) at ¶8 (p. 7).

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.

By: Cogen Technologies Linden Ltd., its general partner

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By: 

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