



Via Electronic Submission

June 22, 2015

Mr. Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Comments of the American Gas Association, CFTC Proposed Rule, Trade Options, RIN No. 3038-AE-26 (May 7, 2015).

Dear Mr. Kirkpatrick:

The American Gas Association (“AGA”) appreciates the opportunity to comment on the Commodity Futures Trading Commission’s (“CFTC” or “Commission”) re-proposal regarding commodity trade options (the “Proposal” or “Proposed Rule”).¹

AGA thanks the Commission for developing a proposal that is responsive to the AGA comments filed pursuant to the interim final Commodity Options rulemaking,² and the AGA remarks and comments pursuant to the CFTC Energy and Environmental Markets Committee Meeting in February 2015. Additionally, AGA commends the Commission for issuing an interpretation that permits re-classification of certain trade options as forward contracts based on clarifications to the CFTC’s seven-element framework for excluded forward contracts with embedded volumetric optionality.³

AGA submits these comments urging the Commission to swiftly issue a final Trade Options Exemption rule (“Final Rule”) that eliminates the annual Form TO reporting requirement for all market participants. AGA further requests that the Final Rule clearly protect small end-users from trade option tracking, and include more guidance on valuation of natural gas trade options with open-ended quantity and pricing terms. Finally, AGA requests that Commission amend CFTC Rule 32.3 to exclude commodity trade options from future CFTC position limits rules.

¹ Proposed Rule, Trade Options, 80 Fed. Reg. 26200 (May 7, 2015) [hereinafter, “Proposed Rule” or “Proposal”].

² See *Interim Final Rule, Commodity Trade Options*, 77 Fed Reg. 25320 (April 27, 2012); see also *Interim Final Interpretation, Further Definition of Swap, Security-Based Swap, and Security-Based Swap Agreement, Mixed Swaps*, 77 Fed. Reg. 48207, at 48238-42 (August 13, 2012) (“Swaps Release”)

³ Final Interpretation, Forward Contracts with Embedded Volumetric Optionality (May 12, 2015)[hereinafter, “Final Interpretation”].

I. Communications

All correspondence in regard to this proceeding should be delivered to the following:

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II. Identity and Interests

The American Gas Association, founded in 1918, represents more than 200 local energy companies that deliver clean natural gas throughout the United States. There are more than 71 million residential, commercial and industrial natural gas customers in the U.S., of which 92 percent — more than 65 million customers — receive their gas from AGA members. AGA is an advocate for natural gas utility companies and their customers and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international natural gas companies and industry associates. Today, natural gas meets almost one-fourth of the United States' energy needs.

AGA's members engage in financial risk management transactions in markets regulated by the Commission. AGA member companies provide natural gas service to retail customers under rates, terms and conditions that are regulated at the local level by a state commission or other regulatory authority with jurisdiction. Many gas utilities use a variety of financial tools, such as futures contracts traded on Commission-regulated exchanges and over-the-counter energy derivatives, to hedge the commercial risks associated with providing safe, reliable and cost-effective natural gas service to its customers. As such, AGA's members will be directly affected by the Commission's regulations governing position limits for futures and swaps.

III. Comments

A. AGA Supports the Elimination of Form TO for all End-Users, Appreciates the Additional Guidance Provided by the Commission to Gas Utilities for Re-assessing Whether Physical Natural Gas Peaking Supply Agreements are Excluded from Trade Option Regulation, and Requests Further Guidance to Finalize the Issue.

AGA supports the CFTC's proposed elimination of Form TO, and agrees with observations in the Proposed Rule that the surveillance benefits of Form TO are outweighed by the various costs that the filing requirement has imposed on small end-users. AGA believes the elimination of the Form TO requirement, along with the CFTC's guidance in the Final Interpretation regarding re-characterization of certain contracts reported on prior calendar year(s) Form TO filings, will help restore physical marketplace liquidity and reduce contracting and compliance costs. AGA also agrees that the CFTC will be able to adequately fulfill its regulatory mission to oversee the options marketplace through the recordkeeping provisions of Rule 32.3(b).

Relatedly, AGA believes the Final Interpretation provides the natural gas marketplace additional supporting guidance to help clarify that certain natural gas supply contracts, such as gas utilities' peaking supply, bullet-day, and swing contracts, with or without a minimum gas delivery requirement, do not have to be classified as commodity trade options. AGA particularly appreciates that the CFTC reiterated in the Final Interpretation, the following points:

- (i) In assessing the parties' expectations or intent to deliver (a pre-condition of the historic forward contract exclusion), the CFTC seeks to consistently apply a "facts and circumstances" approach. By example, embedded optionality would or would not be consistent with the CFTC's historical interpretation, based on the intent of the parties and other facts and circumstances such as the parties' course of performance or intent to defer delivery based on objective criteria, such as the pattern of deliveries in relation to variation in weather, customer demand, or other similar factors."⁴
- (ii) Depending on the relevant facts and circumstances, capacity contracts, peaking supply contracts, transmission or transportation service agreements, and tolling agreements, may qualify as forward contracts with embedded volumetric optionality, provided they meet the elements of the CFTC's Final Interpretation.⁵
- (iii) Commercial parties may rely on counterparty representations with respect to the intended purpose of the embedded optionality, provided that they do not have information that would cause a reasonable person to question the representation's accuracy.
- (iv) To be consistent with the CFTC's historical interpretation regarding forward contracts, the primary purpose of forward contracts eligible for exclusion must be the transfer of commodity ownership of the commodity and not the sole transfer of its price risk.⁶ Further, the embedded volumetric optionality "must primarily be intended as a means of assuring a supply source or providing delivery flexibility in the face of uncertainty regarding the quantity of the nonfinancial commodity that may be needed or produced in the future, consistent with the purposes of a forward contract."⁷ Forward contracts with volumetric optionality permit end-users to have agreements in place so that they can effectively and economically manage the purchase or sale of commodities related to their commercial businesses, not as a substitute for a financially settled contract or for speculative purposes... although the "amounts that can be taken on delivery may vary, the primary intent of the contracts is not to provide price protection."⁸

However, the physical natural gas marketplace continues to seek clear guidance to resolve the outstanding ambiguity that stand-alone, zero-minimum volume natural gas peaking supply

⁴ See Final Interpretation at pp. 9, note 24.

⁵ See Final Interpretation at pp. 10, note 32.

⁶ See Final Interpretation at pp. 8 (citing Products Release, 77 Fed. Reg. at 48228).

⁷ See Final Interpretation at pp. 8.

⁸ *Id.*

contracts/swing supply contracts without specific baseload provisions, can be properly classified as exempt forward contracts. The Final Interpretation alone cannot be the basis for market participants to perform a clear analysis because the Commission did not directly address and explain in the Final Interpretation, as AGA had requested in prior comments, that all contracts bearing the underlying characteristics of a forward, including zero-minimum peaking supply contracts, may be analyzed consistent with CFTC guidance on the forward contract exclusion.

AGA believes the regulatory preamble of the final rule regarding Commodity Trade Options, would be an appropriate place for the Commission to address this issue. The Commission should clarify, in its regulatory preamble to the Trade Options final rule that the CFTC's forward contract precedent, options precedent, Trade Options regulations, and Final Interpretation should be read together by market participants to determine whether or not certain physical delivery agreements, including those with no "minimum delivery" terms, are excluded forwards or trade options.

AGA respectfully urges that this issue not be addressed through non-binding guidance, opinion statements, concurrences, or other approaches that do not require the Commissioners to reach broad consensus and formally vote on the Commission's position. The fact that both the Final Interpretation and the Trade Option Proposal contained conflicting individual views from agency leadership on how the legal analysis should be conducted, has continued the confusion and uncertainty for end-user market participants that hoped to gain more clarity from the Commission's work. We respectfully remind the Commission that the purpose of the Final Interpretation and the Trade Options Proposal was ostensibly to help energy sector end-users, including those represented by AGA, make well-reasoned decisions that would not result in the illogical, arbitrary regulation of a critical subset of non-financial, forward contract instruments that may only and exclusively settle in physical natural gas delivery, to be regulated under "swaps" or "options" authority while every other forward contract would be excluded from CFTC regulation.

AGA emphasizes that this issue must be resolved now, in the Commodity Trade Options docket, to ensure that the physical natural gas marketplace has the regulatory certainty it needs. The CFTC has already created a substantial record that would aid market participants' legal analysis, including the Swaps Release, Office of General Counsel guidance, Final Interpretation, and Commodity Trade Option regulations. AGA urges the Commission to stand by this prior work in taking any further steps to provide more clarity on this issue. The Commission's approach to this issue should provide closure for AGA and several other energy stakeholders that have repeatedly demonstrated to the Commission in written comments that natural gas peaking supply and other flexible delivery agreements, even those with no contractual "minimum" delivery term, have the same fundamental characteristics as other types of physical delivery contracts which qualify for the CFTC's forward contract exclusion. AGA looks forward to a clear acknowledging statement to this effect in the final Trade Options rule preamble.

In addition to this suggested approach, AGA asserts that any further clarity would be best offered through an overarching fix to the Commodity Exchange Act's exclusions from the definition of a "swap". A statutory fix would fully address Commissioner Bowen's concern that "both forward contracts and trade options play an important role in managing the physical

commodity risks attendant to commercial operations” – and ensure that these contracts are not mischaracterized as “swaps”.⁹

For the aforementioned reasons, AGA supports the elimination of CFTC Form TO, and believes that the CFTC’s recordkeeping framework will provide adequate regulatory oversight of the options marketplace. AGA also commends the Commission for providing helpful guidance in the Final Interpretation, which will assist natural gas utilities in making appropriate re-classification decisions to exclude from CFTC reporting certain natural gas peaking supply, bullet-day and other physical delivery instruments which were potentially mischaracterized as financial options in prior Form TO filings. Finally, AGA urges the Commission to bring this issue to final resolution and clarify in the Trade Options final rule preamble, as noted above, that all prior rules, guidance and precedent on this issue apply equally to agreements with no minimum delivery requirements.

B. The Final Rule Should Clearly Protect Small End-Users from TO Tracking Obligations and Include Examples Regarding Valuation of Natural Gas Trade Options with Open-Ended Quantity and/or Floating Price Terms.

AGA is generally supportive of the CFTC’s proposed alternative reporting framework for trade options, under which end-users would be required to provide email notice to the CFTC Division of Market Oversight if they enter into, or expect to enter into, trade options having an aggregate notional value in excess of \$1 billion in any calendar year. AGA agrees with the CFTC’s observation in the Proposal that the \$1 billion notice requirement is sufficient to help the agency gauge the size of the unreported trade options marketplace and identify its most significant market players. AGA commends the CFTC for recognizing, through this proposed framework, that imposing reporting requirements, like Form TO, on smaller end-users is justified neither by the costs to these entities, nor by any perceived benefits to the CFTC’s surveillance goals.

However, AGA respectfully urges the CFTC to make additional clarifications in the Final Rule to ensure that the Proposal’s intended regulatory relief for smaller end-users is actually effectuated in the Commission’s implementation of the new \$1 billion notice requirement.

First, AGA requests that the CFTC re-state in the regulatory text or preamble of the Final Rule, that no tracking of trade options would be required for a specific calendar year if the end-user does not reasonably expect, based on the value of its historic trade options in the ordinary course of business, to enter into trade options with an aggregate notional value in excess of \$1 billion during that year.¹⁰ This guidance would be very helpful for gas utilities and other small end-users that have not historically engaged in trade options approaching or above the \$1 billion threshold, and would permit them to make ex-ante decisions that tracking is not necessary when their trade option activities would likely fall well under the \$1 billion threshold. AGA believes this is a workable rule that will not interfere with the Commission’s efforts to identify abnormal or suspect market activity.

⁹ See Concurring Statement, Sharon Bowen, Trade Options, 80 Fed. Reg. 26200, 26209-10 (May 7, 2015).

¹⁰ See *Regulatory Flexibility Analysis*, Proposed Rule, 80 Fed. Reg. 26200, 26207 (“Furthermore, Non-SD/MSPs that reasonably expect to enter into trade options with an aggregate notional value in excess of \$1 billion during the calendar year may, in line with the Alternative Notice, simply send an email to DMO to that effect, thereby avoiding having to track the notional values of their trade options.”).

Second, AGA requests that the CFTC specify in the Final Rule that, for valuation of a trade option with a floating price term, an end-user could ascertain a “current market price” by reference to any appropriate local index price, or another liquid point such as the NYMEX HH NG futures contract price, for the future month of expected delivery in which the end-user has the right to exercise on specific day(s). The Proposed Rule only contemplates that a trade option with a floating price term could be valued by calculating maximum deliverable quantity under the contract by a “current market price of the underlying commodity that is deliverable on, or similar to, a nearby reference contract for the commodity” and that these calculations are to be based on the value of the trade option at the time of contract initiation, not at exercise. This proposed approach does not provide complete and accurate guidance for natural gas trade option valuation.

For one, the universe of contracts that might be classified as natural gas trade options includes highly customized instruments for physical delivery that may not reference a standardized futures contract for the underlying natural gas commodity. In some cases, gas delivered under these arrangements might be to a specific gas utility city-gate delivery point, making even pipeline indices irrelevant to valuation. Therefore, for the transactions that are classified as trade options, natural gas market participants need more flexibility to choose an appropriate index or liquid point for pricing these arrangements for purposes of the \$1 billion notice requirement. Further, gas utilities enter into natural gas supply arrangements in non-peak months, often in the year prior to the month or year of delivery, when expected delivery prices (e.g., May 2015) may be published at prices that are substantially lower than the expected prices for delivery in the future month (e.g., January 2016). Therefore, AGA recommends that for ascertaining “current market price” of floating-price natural gas trade options, it is more appropriate to use the forward market price for the month of expected delivery, *not* the current spot or cash market price on the day the contract is initiated.

To address this concern, AGA requests that the CFTC specifically include the following example in the Final Rule:

Example 1 – Valuation of Floating Price Natural Gas Commodity Trade Option for Future Delivery

For a natural gas commodity trade option that does not have a fixed strike price or exercise price reflected in the agreement, and is entered into in a current month with a contractual obligation to deliver physical commodity on any day or several days of a future month, the applicable “market price” the end-user may use for valuation calculation is the forward or expected price for delivery in the future month, *not* the daily or monthly delivery price in the current month during which the contract is initiated. Using the forward market price for the *month* of expected delivery, although not necessarily the specific *day* on which gas delivery occurs upon exercising or striking the option, is consistent with the CFTC’s proposed approach in the Proposed Rule that calculations are to be based on the value of the trade option at the time of contract initiation, not at the time of exercise of the option.

Third, the CFTC should provide more guidance on valuation methodology for natural gas transactions that are classified as trade options that have no minimum quantity or maximum quantity terms. While the Proposed Rule addresses valuation for fixed and floating prices, it does not address valuation issues related to open-ended quantity terms that are common in the gas

industry. To this end, AGA requests that the CFTC specifically include the following example in the Final Rule:

Example 2 – Natural Gas Commodity Trade Option with No Minimum Take Requirement

For a natural gas commodity trade option that has no *minimum* quantity take requirement, and is priced at a published daily index (and there is no daily future index to use for calculating notional value), the end-user could value that contract using independent third party monthly forecast data, such as PIRA Energy Group or IHS Cambridge Energy Research Associates monthly forecast data (consistent with, for example, how a gas utility reports values for its regulatory gas cost recovery pass-through filings), for the current month's prices. This methodology would be appropriate even if the future delivery price at which the trade option is exercised, is higher than the current month prices used for valuation. This approach is also consistent with the CFTC's proposed approach that calculations are to be based on the value of the trade option at the time of contract initiation, not at the time of exercise of the option.

Fourth, the CFTC should state that in valuing a trade option with an open-ended quantity term, the volume can be determined using historic volumes or expected volumes, so long as there is a reasonable basis for that determination. Further, the CFTC should state that for trade options with open-ended price terms, a price used may be based on futures or forward information made available from a generally available independent third party provider that is an available source for such information. The CFTC should not restrict or prescribe the price source that could be used by market participants to obtain this valuation information. AGA notes that the above examples and clarifications are necessary guidance for the gas industry, and will also better serve the Commission's interest in an accurate and comprehensive framework for gauging the size of the trade option marketplace.

Fifth, it would be helpful for the CFTC to also explain how the appropriate "maximum" volume would be identified for an exchange transaction that has two "legs" for the overall transaction:

Example 3: Exchange Transaction, Natural Gas Trade Option

For a natural gas commodity exchange transaction with a term of "up to 50,000 MMBtu" maximum volume for each party to the exchange, would the counterparty use 100,000 MMBtus, the sum of both legs of the exchange, as the maximum volume figure for the purposes of valuing the trade option, or would the party use 50,000 MMBtus as the maximum volume figure, basing the maximum amount only on the amount which each individual party is entitled to under the exchange contract. The CFTC should clarify which approach is preferred, or whether either approach may be used by the parties, e.g. would it be appropriate to use a maximum based on both legs of the exchange combined, or use a netted maximum quantity as per GAAP rules. Likewise, the Commission should clarify if the commodity price varies for both legs of the exchange, would the valuation calculation be based on either price applicable to each individual leg of the exchange, or based on the delta between the two different prices. There may also be no current price/contract initiation price, in which case the CFTC's recommended methodology for valuing floating

price contracts would apply to the exchange contract as well, providing sufficient discretion to the parties to use a future delivery month price based on available third party data sources. In this discussion, the CFTC should also explain that these examples are in aid of providing market participants necessary flexibility to develop a rational valuation methodology for open-ended contracts.

Finally, AGA requests that the CFTC include a safe harbor in its Final Rule that would cover how natural gas market participants currently value, and may change their valuation methods going forward, based on changing CFTC staff views or new guidance on trade options. The safe harbor provision would state that if a market participant's originally-developed methodology, for historic TO reporting or prospective tracking and reporting, requires after-the-fact revisions light of changing CFTC views or new guidance, such revisions would not be a basis for CFTC staff to recommend an enforcement action against the market participant.

AGA urges the CFTC to include these examples, discussion and safe harbor provision to ensure that gas utilities and their physical market counterparties can continue to hedge physical supply risks and comply with the new trade option regulations without generating confusion or disagreement about compliance obligations or potential enforcement risks associated with tracking and valuing trade options.

C. The CFTC should Amend Rule 32.3 to Specifically Exclude Commodity Trade Options from Speculative Position Limits.

AGA urges that in addition to striking references in Rule 32.3 to the application of Part 151 Position Limits in this proceeding, the CFTC should explicitly amend Rule 32.3 to prospectively exclude commodity trade options from future position limits rules.¹¹ In its Proposed Rule, the Commission has undertaken a significant effort to reduce reporting burdens on end-users and better focus its regulatory mission on monitoring major players in the options marketplace. The proposed elimination of Form TO, for example, could reduce a significant compliance cost and obviate the need for small end-users to track and report their trade options activity for a given calendar year. However, if a position limits exclusion is not addressed in Rule 32.3, the potential relief offered by the Proposed Rule would be marginalized by the uncertainty that end-users face by not knowing if they might be required to track trade options at a future date for position limits compliance. For example, it is unlikely that small end-users will make any significant changes to how they presently track trade options (and expend resources on these activities), until there is a clear message from the regulator on whether a future position limits rule might apply to their trade options.

AGA reiterates its prior comments that imposing position limits on trade options is contradictory and counterproductive to how the CFTC itself anticipates fulfilling its regulatory

¹¹ See also Supplemental Comments of the American Gas Association, Energy and Environmental Markets Committee, March 30, 2015 [arguing that any position limits final rules should categorically exclude Trade Options from position limits because Trade Options, by definition, are physical delivery instruments designed to provide delivery of the underlying physical commodity and are in no way similar to positions that financially hedge the risks of physical assets].

surveillance mission with respect to the trade options marketplace. The Proposal would eliminate Form TO, given the CFTC's acknowledgement of its limited value and its belief that a notice filing is sufficient to patrol the market for suspect behavior and to identify its biggest players. As the CFTC believes that there is no additional regulatory surveillance benefit from requiring each small end-user to track and aggregate trade options data for Form TO, it is arbitrary for the CFTC to also assert any potential regulatory surveillance benefit from requiring each small end-user to track and aggregate trade options data for position limits purposes.

Finally, AGA notes that subjecting trade options to position limits reporting would not likely provide any new data serving the Commission's interests in patrolling the options marketplace. Specifically, a position limits recordkeeping or tracking obligation would not result in any substantive contributions to what the CFTC would collect through the Proposed Rule's \$1 billion notice requirement. The Proposed Rule generally calls for all market participants to be able to value and track *all* of their trade options, which for natural gas, includes those based on prices referencing any one of hundreds of index prices throughout North America. This encompasses potentially hundreds of natural gas trade option contracts that would be tracked for potential reporting purposes to the CFTC, and for which the market participants involved must maintain books and records. And yet, only a fraction of those contracts would be covered under the CFTC's proposed position limits reporting scheme, which envisions position limits applying only to trade options that qualify as "referenced contracts" linked to the NYMEX HH NG core contract price or those priced at other indices but deliverable to Henry Hub. If the Commission's overarching regulatory concern is in fact to monitor the entire trade option marketplace, that mission appears to be adequately and cost-effectively fulfilled by the Proposed Rule. Requiring only a subset of that marketplace to comply additionally with position limits rules, is illogical and unhelpful to the Commission's regulatory interests.

For these reasons, AGA respectfully concludes that the costs of a position limits requirement on commodity trade options is wholly unjustified by any perceived benefits to the Commission's interests in monitoring financial markets for excessive speculation and monitoring the options markets to identify major players and potentially suspect activity. Accordingly, AGA urges the Commission to amend Rule 32.3 in its Final Rule to provide a clear exclusion for commodity trade options from any future position limits rules.

IV. Conclusion

AGA supports the Commission's efforts to lessen burdens on gas utilities and other end users through the Proposed Rule. AGA appreciates this opportunity to comment and looks forward to the expedient issuance of a final rule that codifies the elimination of CFTC Form TO and provides additional clarifications requested herein.

Sincerely,

American Gas Association

CC: Chairman Timothy Massad
Commissioner Sharon Bowen
Commissioner J. Christopher Giancarlo
Commissioner Mark Wetjen