



March 23, 2012

Honorable Gary Gensler, Chairman
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

RE: *Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”*; *Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, RIN 3038-AD46, 76 Fed. Reg. 29,818 (May 23, 2011); and *Commodity Options and Agricultural Swaps*, 76 Fed. Reg. 6,095 (Feb. 3, 2011).

Dear Chairman Gensler:

Thank you for meeting with members of the American Gas Association on February 2. We are writing to follow up on the questions that you asked and to provide some of the information requested, including the nature and pricing of physical peaking supply contracts prevalent in the natural gas industry.

As discussed in the meeting, 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. Each year, natural gas utilities develop plans to reliably meet the gas supply needs of their retail customers through a portfolio of physical supply, storage and transportation services. The primary use of natural gas by residential and commercial customers is for space and water heating, therefore, retail demand for natural gas is weather driven, and weather is difficult to precisely predict. Gas utilities use several kinds of resources to meet the gas supply needs of their customers during periods of peak system demand, *i.e.*, the coldest days or weeks of the winter heating season. Peaking supply contracts, for example, provide utilities with the flexibility to take delivery of the gas when needed to meet peak customer demand. AGA remains concerned that notwithstanding the physical nature and intent of these gas supply contracts, the Commission may view the delivery flexibility of such contracts as a “commodity option” subject to regulation as a “swap.”

AGA filed comments on July 22, 2011, in the *Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”*; *Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, rulemaking proceeding, RIN 3038-AD46, urging the Commission to clarify that the types of physical peaking supply contracts prevalent in the energy industry are commercial contracts intended to be physically settled and/or contain commodity options embedded in forward contracts that are intended to be physically settled such that they would be excluded from the definition of a “swap.”

During the meeting on February 2, you suggested that the issue may be better addressed in the *Commodity Options and Agricultural Swaps*, rulemaking proceeding. Attached to this letter are the comments AGA filed on July 22, 2011 in the *Product Definitions* proceeding, RIN 3038-AD46. AGA respectfully requests that such comments be included in the comment file in the *Commodity Options* proceeding, and considered when promulgating final rules in that proceeding.

Also discussed during the meeting on February 2 were several characteristics that distinguished these physical peaking supply contracts from commodity options. Such characteristics included the facts that: the delivery flexibility in peaking supply contracts was not severable, not transferable, and extinguished if not exercised; the contracts contained no cash settlement alternative; and the seller/offeror had the obligation and ability to physically deliver the amount of the commodity (natural gas) requested by the purchaser/gas utility.

There was some discussion about typical pricing arrangements under such contracts and whether another distinguishing characteristic might be that the pricing of such contracts typically included index-based instead of fixed pricing. As more fully set forth in the attached comments, peaking supply contract typically include a monthly reservation charge which is a fixed monthly amount that is paid regardless of whether the utility takes delivery of any quantity of gas and a per-unit charge that is paid for each quantity of gas taken under the agreement. The per-unit price is usually based on an index – either the daily index price for the day on which the gas is delivered or in some cases a first-of-the-month price for the month in which the gas is delivered; however, for some contracts the per-unit price is a fixed, negotiated price. Given the variety of pricing mechanisms currently used in the industry, a rule that would exclude certain types of physical peaking supply contracts from the definition of a “swap” on the basis of price – whether index-based or fixed – may impact the market for such products.

We hope you find this information helpful. If you have any questions regarding the information provided, please feel free to contact us.

Sincerely,



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cc: Hon. Bart Chilton, Commissioner
Hon. Scott O'Malia, Commissioner
Hon. Jill Sommers, Commissioner
Hon. Mark Wetjen, Commissioner
David Stawick, Secretary of the Commission
Donald Heitman, Senior Special Counsel

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**UNITED STATES OF AMERICA
BEFORE THE
COMMODITY FUTURES TRADING COMMISSION**

Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”;
Mixed Swaps; Security-Based Swap Agreement
Recordkeeping) RIN 3038-AD46
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**COMMENTS OF THE
AMERICAN GAS ASSOCIATION**

Pursuant to the Notice of Proposed Rulemaking issued May 23, 2011,¹ by the Commodity Futures Trading Commission (“CFTC” or “Commission”), the American Gas Association (“AGA”) respectfully submits these comments. AGA believes that regulations implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act² should ensure that the financial markets related to energy commodities function efficiently and protect the ability of commercial hedgers to engage in risk management activities for the benefit of American energy consumers at reasonable cost. AGA urges the Commission to ensure that its analysis of whether a transaction is a forward contract is robust enough to encompass all of the commercial merchandising transactions in the energy industry normally understood to be and intended to be physically settled. In particular, AGA seeks clarification that physical exchange transactions are forward contracts excluded from the definition of a “swap.” AGA also seeks clarification that peaking supply contracts are not “swaps,” or are considered commodity options embedded in forward contracts intended to be physically settled and thus excluded from the

¹ *Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 76 Fed. Reg. 29,818 (May 23, 2011) (“Notice”).

² Pub. L. No. 111-203 (July 21, 2010) (“Dodd-Frank Act”).

definition of a “swap.” AGA contends that regulating peaking supply contracts will not address systemic risk in the U.S. financial markets or further other policy concerns underlying the regulation of swap transactions. In addition, AGA urges the Commission to apply a forward contracts exclusion to the purchase and sale of environmental commodities such as emissions allowances, carbon offset and credits, and renewable energy certificates.

I. COMMUNICATIONS

All pleadings, correspondence and other communications filed in this proceeding should be served on the following:

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II. IDENTITY AND INTERESTS

The AGA, founded in 1918, represents 201 local energy companies that deliver clean natural gas throughout the United States. There are more than 70 million residential, commercial and industrial natural gas customers in the U.S., of which 91 percent — more than 64 million customers — receive their gas from AGA members. AGA is an advocate for local natural gas utility companies and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international gas companies and industry associates. Today, natural gas meets almost one-fourth of the United States’ energy needs.³ AGA’s members engage in financial risk management transactions in markets regulated by the Commission, including the trading of swaps as may be defined in this proceeding. As such, AGA’s members

³ For more information, please visit www.aga.org.

will be directly affected by the proposed regulations. Accordingly, AGA has a direct and substantial interest in the outcome of this proceeding.

III. COMMENTS

A. Background

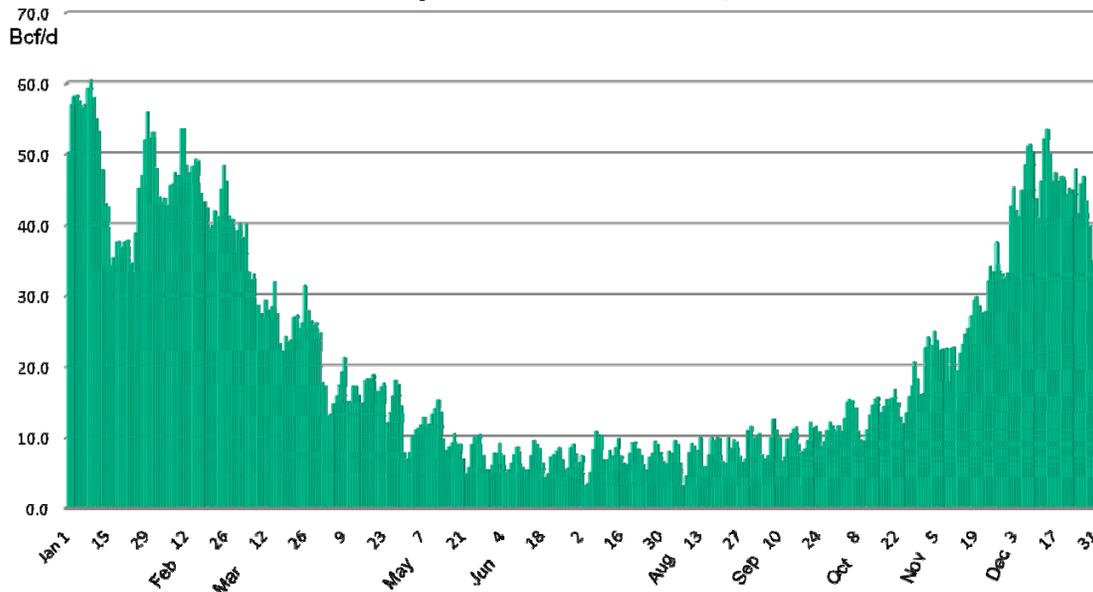
AGA member companies provide natural gas service to retail customers under rates, terms and conditions that are regulated at the local level by a state commission or other regulatory authority with jurisdiction. Each year, natural gas utilities develop plans to reliably meet the gas supply needs of their retail customers. Gas utilities build and manage a portfolio of physical supply, storage and transportation services in order to meet anticipated demand. As such, gas utilities are commercial entities exposed to commodity risks, most especially the price of natural gas commodities. Gas utilities have a strong interest in managing these portfolios to ensure that the overall cost for natural gas service remains stable and at a reasonable cost to their customers.

In general, retail demand for natural gas is weather driven. The primary use of natural gas by gas utility customers is for space and water heating. Consequently, retail customers consume the largest portion of their natural gas during the peak winter months. As Figure No.1 shows, the period of heaviest natural gas usage among residential and commercial customers (gas utilities' core customer base) is in the months of November through March.⁴

⁴ The five-month period from November through March is commonly referred to in the natural gas industry as the winter season.

Residential and Commercial Demand

January 1 – December 31, 2010



Source: Bentek Energy LLC, *Energy Market Fundamentals*, December 31, 2010

Figure No. 1

In building a portfolio of resources to meet customer demands, gas utilities consider the amount of gas that is needed during the various periods of the year, for example how much is needed year-round (baseload supply), how much is needed during the normal winter months (intermediate supply) and how much is needed on the coldest days (peaking supplies). As shown in Figure No. 2, gas utilities use a variety of resources in planning to meet the various portions of their expected load. For example, a utility might use firm transportation and firm gas supplies to meeting its baseload needs, and use a combination of firm transportation and storage withdrawals

"Design" Winter Load Duration Curve

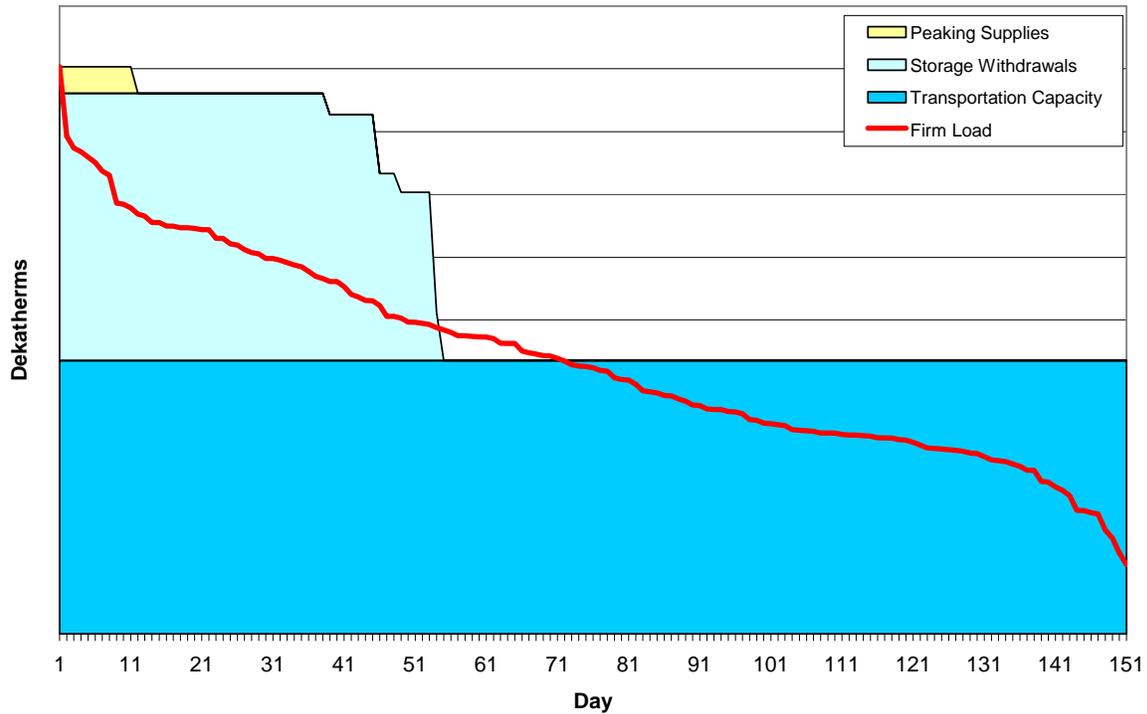


Figure No. 2

to meet its intermediate supply needs. Meeting the peak needs of gas customers presents significant challenges for gas utilities because the weather cannot be precisely predicted. While gas utilities can expect the winter period to contain a certain number of cold days of high gas usage, they cannot know with certainty when those days will occur. For example, as seen in Figure No. 1, in 2010 residential and commercial gas usage peaked in the beginning of January, fell off substantially mid-month, and peaked again at the end of that month. As a result, a gas utility's peaking supplies must have significant flexibility in order for the utility to be able to use them on the days they are needed.

Gas utilities use several kinds of resources to meet the peak needs of their customers. A utility's on-system assets may include propane-air or liquefied natural gas storage facilities.

These systems are often designed to provide a significant quantity of gas but for only a short duration. Thus, they are often reserved for use during a period of unusually cold weather. Gas utilities also use a variety of contracts with gas suppliers to physically deal with peak periods of demand. These peaking supply contracts provide utilities with the flexibility to take delivery of the gas when needed to meet the peak demands of their customers.

Daily Supply Contracts

In some cases, a utility will enter into a gas supply contract in which the utility has the right to take delivery on any day during the term of the contract up to a specified quantity of gas (referred to as the “maximum daily quantity” or “MDQ”). The term of the contract is typically at least one month and may be for the entire five-month winter season. The utility generally pays a monthly reservation charge, which is paid regardless of whether the utility takes delivery of any quantity of gas. The utility also pays a charge for each quantity of gas that is actually delivered/taken. The price is usually based on an index – either the daily index price for the day on which the gas is delivered/taken or in some cases the first-of-the-month index price for the month in which the gas is delivered/taken. For some contracts, the price is a negotiated fixed price. In some cases, the per-unit charge will include an adjustment in lieu of the monthly reservation charge. If the gas utility does not exercise its right to take physical delivery of the gas, there is no cash settlement alternative. The delivery right is simply extinguished. Any monthly reservation charge is paid regardless of whether gas is delivered or taken under the agreement. This type of contract allows the utility to physically deal with the expected day-to-day variations in load normally experienced in the peak winter season.⁵

⁵ A variation of this type of contract allows the utility to specify prior to a particular month a quantity of gas to be delivered each day during that month. These contracts are sometimes referred to in the industry as “take or release” contracts.

Bullet Day Contracts

In other cases, a utility will enter into a gas supply contract in which the utility has the right to take delivery on a specified number of days during the term of the contract up to a specified maximum daily quantity. The term of the contract is usually one to three months, and the number of bullet days on which gas can be taken generally ranges from five to twenty depending on the duration of the contract. The pricing under the contract is similar to daily supply contracts in that there is typically a monthly reservation charge and a per-unit charge for the quantity of gas that is actually delivered/taken. Similarly, the per-unit charge is usually based on an index, either the daily index price or the first-of-the-month price, or it may be a negotiated fixed price. If the right to delivery is not used, any reservation charge is still paid. There is no right to cash settle in lieu of physical delivery. This type of contract allows the utility to physically deal with unusual variations in load such as during a winter storm or a severe cold snap. The utility can expect that it will experience a certain number of high demand days due to storms or severe weather during the peak winter months, but it cannot know the exact days on which those events will occur.

Weather Contracts

Further, a utility may enter into a gas supply contract in which the utility has the right to take delivery on a particular day during the term of the contract up to a specified maximum daily quantity if certain specified weather conditions are forecasted to exist on that particular day. For example, a weather contract may allow the utility to take delivery the next day if the average temperature forecast for that day is expected to be less than a specified temperature. Weather contracts tend to be for only the peak month but may be longer. The pricing is also similar in that there is typically a reservation charge and a per-unit charge for the quantity of gas actually

delivered/taken. The per-unit charge is usually based on a first-of-the-month index price but sometimes references a daily index price. Similarly, there is no cash settlement alternative to physical delivery; any reservation charge is paid regardless of whether any quantity of gas is delivered or taken. This type of contract allows the utility to physically deal with unexpectedly high demand due to extreme weather, or to closely tailor its deliveries to respond to weather-sensitive loads.

All of these types of peaking contracts (Daily or Monthly Supply, Bullet Day, and Weather) are intended to be and are physically settled without an alternative for cash settlement. In general, these contracts use the North American Energy Standards Board (“NAESB”) Base Contract as a platform to negotiate the individual terms. The NAESB Base Contract does not provide for financial settlement. The reservation charge is intended to compensate the supplier for standing ready to provide gas supplies when the utility needs the gas, and the individual volumes are priced based on an agreed-upon index, either daily or monthly, or at a negotiated fixed price. If the utility does not exercise its right to take delivery of a quantity of gas under the contract, then the right to delivery expires. Moreover, if the supplier fails to deliver, the contracts typically contain a liquidated damages provision that would compensate the utility for the cost of having to obtain alternative supplies at the prevailing market price.

Exchanges

In addition to the peaking supply contracts described above, gas utilities may enter into transactions for the physical exchange of natural gas. Many gas utilities are interconnected with and are served by more than one interstate pipeline. It is often the case, even with gas utilities served by only one pipeline, that the utility can receive the gas at more than one interconnection or delivery point on the pipeline. Gas utilities contract with interstate pipelines for capacity

rights to have their gas supplies delivered to specific delivery points. In some cases, a gas utility may enter into a transaction with another gas utility or other market participant to take delivery of a quantity of gas at one delivery point in exchange for the same quantity of gas to be delivered at an alternative delivery point. The price of the exchange transaction will generally reflect the difference in the value of the gas at the different delivery points. These exchanges benefit both parties by rationalizing the delivery of physical supplies to the delivery points where the gas is needed.

B. CFTC's Proposed Rules

In the Notice, the Commission observed that the term “swap” in the Dodd-Frank Act excludes forward contracts, *i.e.*, “any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled.”⁶ The wording of this exclusion is similar, but not identical to the forward contract exclusion from the definition of “future delivery” in the Commodity Exchange Act, which excludes “any sale of any cash commodity for deferred shipment or delivery.”⁷ The Commission explained that forward contracts with respect to non-financial commodities are commercial merchandising transactions, the primary purpose of which is to transfer ownership of a commodity and not to transfer solely its price risk.⁸

The Commission concluded, therefore, that commodity regulation should not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity.⁹

Accordingly, the Commission proposed that with respect to non-financial commodities an intent

⁶ Notice, 76 Fed. Reg. at p. 29,827.

⁷ *Id.*

⁸ *Id.* at p. 29,828.

⁹ *Id.*

to deliver a physical commodity should be a part of the analysis of whether a given contract is a forward contract or a swap.¹⁰ The Commission noted that it recently reaffirmed this principle in concluding that the intent to make or take delivery is the critical factor in determining whether a contract qualifies as a forward.¹¹

The Commission proposed, therefore, that the following principles regarding forward contracts would apply in the context of the definition of a swap: (1) the forward contract exclusion from the swap definition with respect to non-financial commodities should be interpreted in a manner that is consistent with the CFTC's historical interpretation of the forward contract exclusion from the definition of the term "future delivery;" (2) intent to deliver is an essential element of a forward contract excluded from both the swap and future delivery definitions, and such intent in both instances should be evaluated based on the CFTC's established multi-factor approach; and (3) book-out transactions in non-financial commodities that meet the requirements specified in the Brent Interpretation, and that are effectuated through a subsequent, separately-negotiated agreement, should qualify for the forward exclusion from the swap definition.¹²

The Commission noted that it had previously applied an "Energy Exemption" to contracts: (1) entered into by persons reasonably believed to be within a specified class of commercial and governmental entities; (2) that are bilateral contracts between two parties acting as principals; (3) the material economic terms of which are subject to individual negotiation by the parties; and (4) that impose binding obligations on the parties to make and receive delivery of the underlying commodity, with no right of either party to effect a cash settlement of their

¹⁰ *Id.*

¹¹ *Id.* (citing *In re Wright*, CFTC Docket No. 07-02 (Oct. 25, 2010)).

¹² *Id.* at p. 29,829.

obligations without the consent of the other party (except pursuant to a *bona fide* termination right such as default).¹³ The Commission proposed to withdraw its Energy Exemption, while retaining and extending the Brent Interpretation to non-financial commodities.¹⁴

With respect to commodity options and commodity options embedded in forward contracts, the Commission stated that the statutory definition of a “swap” in the Dodd-Frank Act explicitly provides that commodity options are swaps.¹⁵ The Commission stated that it would apply the guidance contained in a 1985 interpretation by the Office of General Counsel to the treatment of forward contracts in non-financial commodities that contain embedded options under the Dodd-Frank Act.¹⁶ The Commission explained that it engages in a two-step analysis of whether embedded options are forward contracts, the first step of which focuses on whether the option operates on the price or the delivery term of the forward contract and the second step focuses on secondary trading.¹⁷ The Commission determined that a forward contract that contains an embedded commodity option or an option that would be considered an excluded non-financial commodity forward contract (and not a swap) is one where the option: (1) may be used to adjust the forward contract price, but does not undermine the overall nature of the contract as a forward contract; (2) does not target the delivery term, so that the predominant feature of the contract is actual delivery; and (3) cannot be severed and marketed separately from the overall forward contracts in which they are embedded.¹⁸ The Commission stated that conversely where the embedded option renders delivery optional the predominant feature of the contract cannot be actual delivery, and the embedded option to not deliver precludes treatment of the contract as a

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.* at pp. 29,829-30 (citing 7 U.S.C. § 1a(47)(A)(i); Dodd-Frank Act § 721).

¹⁶ *Id.* at p. 29,830.

¹⁷ *Id.*

¹⁸ *Id.*

forward contract.¹⁹ The Commission stated that it would look to the transaction as a whole to evaluate whether any embedded optionality operates on the price or delivery term of the contract, and whether an embedded commodity option is marketed or traded separately from the underlying contract, to determine whether that transaction qualifies for the forward contract exclusion from the swap definition.²⁰

C. Comments

AGA is concerned that the Commission’s proposed definitions may not sufficiently exclude from regulation all of the types of commercial merchandising transactions in the energy industry normally understood to be physical contracts. AGA agrees that the definition of a “swap” should be read to exclude forward contracts and other commercial merchandising transactions that are intended to be physically settled. AGA also agrees that the Commission should exclude from the definition of a “swap” certain types of commodity options that are embedded in forward contracts. AGA urges the Commission to ensure that its analysis of whether a transaction would qualify for these exclusions is robust enough to encompass all transactions in the energy industry normally understood to be and intended to be physically settled. Regulating these transactions as “swaps” will not further the policy goals underlying the Dodd-Frank Act, including reducing systemic risk in the U.S. financial markets.

1. Physical Exchanges Should Not Be Considered Swaps.

AGA seeks clarification that physical exchange transactions are forward contracts excluded from the definition of a “swap.” As described above, a physical exchange transaction allows one party to take delivery of a quantity of gas at one delivery point in exchange for the

¹⁹ *Id.*

²⁰ *Id.*

same quantity of gas to be delivered at an alternative delivery point. The primary purpose of the transaction is to transfer ownership of the physical commodity in order to rationalize the delivery of physical supplies to where they are needed. The price of the exchange transaction generally will reflect the difference in the value of the commodity at the different delivery points. In other words, the price term operates to keep the parties whole as to the value of the commodity being exchanged, and thus, does not serve to transfer price risk. The exchange transactions create binding obligations on each party to make and take delivery of physical commodities. In essence, exchanges are paired forward contracts that are intended to go to physical delivery. To the extent a payment stream associated with an exchange transaction uses an index for pricing purposes, the pricing is not severable from the physical exchange. Accordingly, AGA urges the Commission to clarify that physical commodity exchange transactions are excluded from the definition of a “swap” under the interpretive guidance in this proceeding.

2. Peaking Supply Contracts Are Physically Settled Commercial Contracts And Not Swaps.

AGA also seeks clarification that the peaking supply contracts that gas utilities normally enter into would be excluded from the definition of a “swap.” Relying on its recent decision in *In re Wright*,²¹ and its 1985 Interpretation by the Office of General Counsel, the Commission stated that its first step in analyzing commodity options embedded in forward contracts is whether the option operates on the price or the delivery term of the forward contract.²² In particular, the Commission stated that where the embedded option renders delivery optional, the

²¹ CFTC Docket No. 07-02 (Oct. 25, 2010).

²² Notice, 76 Fed. Reg. at p. 29,830.

predominant feature of the contract cannot be actual delivery, and the embedded option precludes treatment of the contract as a forward contract.²³

AGA contends that the physical, peaking supply contracts described above do not render delivery optional within the meaning of the Commission's analysis. Although the purchaser in each of these types of transactions has the option to specify when and if the quantity of gas will be delivered on any given day, there is no alternative for cash settlement. If the purchaser does not exercise the right to purchase, then the right is terminated. The seller under the transaction must make delivery of all of the quantities of gas that the purchaser specifies, or pay liquidated damages. The utility's decision in specifying the quantity of gas to be delivered on any particular day is driven by its physical operations. The quantity specified by the utility under these types of transactions is based on the forecasted need for the commodity by its retail customers.

Further, the pricing structures of these types of transactions reinforce the notion that the overall nature of these transactions is that they are forward contracts. As noted above, there is no incentive, and in many cases a strong disincentive, for the seller to fail to deliver any quantity of gas specified for delivery under the contract. Typically, failure to deliver would result in the seller having to pay liquidated damages sufficient to compensate the purchaser for having to obtain alternative supplies at the prevailing market price. In other words, the seller has no real opportunity to arbitrage its obligation to deliver based on changes in price. Equally, there is no incentive for the purchaser to fail to take delivery of its specified quantities of gas because they are needed for the physical operations of its system.

²³ *Id.*

A liquidated damages provision is consistent with the character of these contracts as forward contracts. The utility enters into these contracts to ensure that it will have the physical gas needed to meet the peak demands of its customers. While in some instances a utility may take delivery of gas supplies that turn out to be in excess of its customers' needs and resell that excess gas to recoup a portion of its costs, these arrangements are not for speculative purposes. Utilities are in the business of selling natural gas to their retail customers, and a utility will sell excess gas supply to others as part of the normal course of business to minimize its overall costs. This is consistent with the characteristics of a physically settled, commercial contract entered into by an entity in the business of buying and selling a physical commodity such as natural gas.

For all these reasons, AGA requests that the Commission find that the peaking supply transactions described herein do not target the delivery term or render delivery optional such that these types of transactions would be considered swaps. Even if the Commission were to consider the ability of the purchaser under these types of transactions to specify a quantity for delivery as a commodity option that operates on the delivery term, AGA contends that the Commission should nonetheless find that the commodity option is embedded in a forward contract excluded from the definition of a "swap."

The second step in the Commission's analysis regarding embedded commodity options focuses on secondary trading, *i.e.*, whether the option can be severed and marketed separately from the overall forward contract in which it is embedded.²⁴ At bottom, the option to specify a quantity of natural gas for delivery on a particular day in the peaking supply contracts described herein cannot be severed or marketed separately from the gas supply agreement itself. There would be little or no incentive for the seller under the contract to allow for secondary trading of

²⁴ Notice, 76 Fed. Reg. at p. 29,830.

the option because of the difficulty in keeping track of which entity would have the right to call upon which quantity of gas. In fact, there is no secondary market for such options.

Moreover, no purpose would be served by regulating these types of transactions as swaps. The counterparty risks are addressed in the contracts themselves. From the purchaser's perspective, the risk that the seller will fail to deliver is typically handled contractually by liquidated damages provisions that compensate the purchaser for having to obtain alternative supplies at the prevailing market price. From the seller's perspective, the credit exposure is addressed in the provisions of the NAESB Base Contract which the parties typically use, and in the ability of the seller to specify the maximum daily quantity in the contract. As a result, regulation of these types of peaking supply transactions is not necessary to reduce risk among the counterparties or reduce systemic risks that would threaten the financial system of the United States. Accordingly, AGA respectfully requests that the Commission clarify as part of any final rules in this proceeding that the types of peaking supply contracts prevalent in the energy industry to meet the physical, operational needs of customers as described herein are commercial contracts intended to be physically settled and/or contain commodity options embedded in forward contracts intended to be physically settled and are thus excluded from the definition of a "swap."

3. Environmental Commodity Transactions Should Not Be Considered Swaps.

Finally, in the Notice the Commission requested comment on whether the forward contract exclusion from the swap definition should apply to environmental commodities such as emissions allowances, carbon offsets and credits, or renewable energy credits.²⁵ AGA believes that the Commission should indeed apply a forward contract exclusion to such commodities. As

²⁵ Notice, 76 Fed. Reg. at p. 29,832.

AGA noted in its comments to the Commission in response to its request for public input on its carbon market study,²⁶ AGA and its member companies have a substantial interest in the efficient operation of markets for the physical trading of carbon allowances as well as the markets for the trading of financial derivatives associated with carbon allowances.

The Commission noted in its carbon market study that typical cap-and-trade programs allow regulated sources to surrender an allowance for every unit of pollution that they emit during the relevant compliance period.²⁷ Other environmental commodities similarly entitle a regulated entity to obtain credit for an offset of carbon, or for the generation of electricity from a renewable resource. AGA contends that the purchase and sale of an environmental allowance is a physical transaction because the predominant feature of the transaction is to transfer ownership of the right to emit a specified unit of pollution. As with other physical commodities, a transaction to transfer ownership of the allowance can be said to be physically settled. Moreover, once the allowance is purchased there is no further financial obligation between the parties, and the rights under the allowance are extinguished with the physical emission of the pollutant. For these reasons, the initial purchase or sale of these allowances or credits should be excluded from regulation as “swaps” just as forward contracts are excluded.

To the extent that derivatives markets develop to help allowance market participants manage the price risk associated with having to purchase or sell such allowances, the Commission can and should regulate those derivatives as swaps to ensure that the financial market is efficient and free of manipulation. In that manner, the Commission would fulfill the role intended by Congress in the Dodd-Frank Act to ensure transparency and reduce systemic

²⁶ *Public Input for the Study Regarding the Oversight of Existing and Prospective Carbon Markets*, 75 Fed. Reg. 72,816 (Nov. 26, 2010).

²⁷ *Report on the Oversight of Existing and Prospective Carbon Markets*, Interagency Working Group for the Study on Oversight of Carbon Markets (Jan. 18, 2011), at p. 5.

risk in the financial markets in the United States. Accordingly, AGA urges the Commission to apply a forward contract exclusion to the purchase and sale of environmental commodities such as emissions allowances, carbon offset and credits, and renewable energy certificates.

IV. CONCLUSION

Wherefore, for the reasons stated above, the American Gas Association respectfully requests that the Commission considers these comments in this proceeding.

Respectfully submitted,

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July 22, 2011