UNITED STATES OF AMERICA
BEFORE THE
COMMODITY FUTURES TRADING COMMISSION

Commodity Options ) RIN 3038-AD62

COMMENTS OF THE
AMERICAN GAS ASSOCIATION

Pursuant to the Final Rule and Interim Final Rule issued April 27, 2012, by the Commodity Futures Trading Commission (“CFTC” or “Commission”), the American Gas Association (“AGA”) respectfully submits these comments. AGA believes that physical, peaking supply transactions should not be subject to regulation by the Commission either as “swaps” or as “commodity options.” AGA respectfully requests that the Commission clarify in either this proceeding or in the proceeding involving the definition of “swap” that the types of peaking gas supply contracts prevalent in the energy industry are forward contracts intended to be physically settled such that they would not be considered “swaps” or “commodity options” notwithstanding the fact that they contain certain flexibility as to the delivery terms. In the alternative, to the extent the Commission believes that peaking supply contracts with delivery term flexibility should be regulated, AGA believes that such transactions entered into by gas utilities should be subject to less stringent regulatory requirements than have been proposed under the trade option exemption, as discussed further in these comments. In particular, AGA contends that gas utilities and other non-swap dealers or major swap participants should only be required to report trade options on an annual basis and should not be required to comply with all of the Commission’s Part 45 reporting requirements with respect to their trade option transactions.

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 more than 200 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. AGA’s members engage in financial risk management transactions in markets regulated by the Commission, including the transactions that may be considered trade options. As such, AGA’s members will be directly affected by regulations promulgated under the Dodd-Frank Act.

III. COMMENTS

A. Background

As AGA has described in previous comments in this and other proceedings, AGA member gas utilities provide natural gas commodity sales and distribution service to their retail customers under rates, terms and conditions that are regulated by state commissions or other

2 For more information, please visit www.ag.org.
regulatory authorities. As part of performing natural gas sales and distribution functions, gas utilities develop detailed long-term plans that are subject to periodic update, review and approval processes. The purpose of these plans is to ensure that gas utilities can reliably meet the gas service needs of their customers on peak days at the lowest reasonable cost. This process includes building and managing portfolios of physical natural gas supply, and building or contracting for storage and pipeline transportation services in order to meet anticipated peak day customer needs.

On July 22, 2011, AGA filed comments in response to the Commission’s May 23, 2011 notice of proposed rulemaking regarding, among other things, the definition of a “swap.” 3 In its comments, AGA explained that gas utilities plan for and use a variety of physical assets to meet peak day customer demand, including peaking natural gas supply contracts such as daily supply contracts, bullet day contracts and weather contracts. These peaking supply contracts provide gas utilities with much-needed flexibility to request the delivery of volumes of natural gas on short notice to meet peak customer demands.

AGA argued that the Commission should ensure that its analysis of whether a transaction is a forward contract or a commodity option embedded in a forward contract is sufficiently robust. In particular, AGA sought clarification that to the extent the delivery flexibility in peaking supply contracts is considered a commodity option, the transactions should nonetheless be viewed as containing commodity options embedded in forward contracts intended to be physically settled, and as such should be excluded from the definition of a “swap.”

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On March 23, 2012, AGA sent a comment letter to the Commission requesting that its July 22, 2011 comments on the Products Definition NOPR should be considered in this proceeding. In the event the Commission determined to address in this proceeding whether peaking supply contracts (i.e., contracts with delivery flexibility) should be excluded from the definition of a “swap.” AGA expressed the concern that notwithstanding the physical nature of peaking supply contracts, the Commission may view the delivery flexibility of such contracts as a “commodity option” and subject them to regulation as “swaps.” AGA urged the Commission to exclude these types of peaking supply contracts prevalent in the energy industry from the definition of “swap.” A copy of the March 23, 2012 comment letter, including the July 22, 2011 comments, is attached.

B. CFTC’s Proposal

In the Final Rule in this proceeding, the Commission determined that commodity options, i.e., options on contracts of sale of a commodity for future delivery, would be able to be traded subject to the same rules as “swaps.” The Interim Final Rule proposed to create an exemption from certain swaps regulations for “trade options.” The trade option exemption would apply to certain physically delivered commodity options used by commercial entities in connection with their commercial activity.

For a commodity option to be a “trade option,” the offeror, offerree, and the transaction must meet certain requirements, including that: (1) the offerree must be an Eligible Contract Participant or a producer, processor, or commercial user of, or a merchant handling the commodity underlying the option transaction and offer or enter into the transaction solely for the purposes related to its business as such; (2) the offerree must also be a producer, processor, or

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5 Id. at p. 25,326. See proposed § 32.3.
commercial user of, or a merchant handling the commodity underlying the option transaction and 
be offered or enter into the transaction solely for the purposes related to its business as such; and 
(3) the commodity option must be intended to be physically settled such that its exercise would 
result in the sale of an exempt or agricultural commodity for immediate or deferred delivery.⁶

While the trade option exemption would operate to exempt the parties to the transaction 
from significant swap regulations, the exemption is only partial, as the Interim Final Rule 
determined that trade options would still be subject to certain requirements, such as swap 
reporting and recordkeeping regulations.⁷ Entities entering into trade option transactions must 
comply with the swap data recordkeeping and reporting requirements under Part 45 of the 
Commission’s regulations.⁸ Among other things: (1) if a counterparty is already reporting other 
(non-trade options) swaps under Part 45 reporting, it must continue to be the reporting entity for 
Part 45 reporting of trade options; and (2) if a counterparty did not previously report swap 
transactions under Part 45, any trade options entered into in the prior calendar year must be 
reported by both counterparties, in an annual notice filing to the Commission on new Form TO.⁹ 
Additionally, entities entering into trade options must comply with the large trader reporting 
regulations under 17 C.F.R. Part 20 and position limits regulations under 17 C.F.R. Part 151.¹⁰ 
The Commission noted that because trade options are commonly used as hedging instruments or 
in connection with some commercial function, they would normally qualify as hedges and thus 
would be exempt from the position limits rules.¹¹

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⁶ *Id.*; *see also* proposed §§ 32.3(a)(1) – (3). 
⁷ *Id.* at pp. 35,326-27. 
⁸ *Id.* at p. 35,327. 
⁹ *Id.*; *see also* proposed §§ 32.3. 
¹⁰ *Id.* *see also* proposed § 32.3(c)(1) – (2). 
¹¹ *Id.* at p. 25,328, fn. 50.
The Commission sought comment on whether the interim final rule provides an appropriate regulatory framework for trade options and whether the trade option exemption preserves appropriate hedging opportunities for current users of the trade options market.\textsuperscript{12}

\textbf{C. Comments}

1. \textbf{Natural Gas Supply Contracts With Volumetric Delivery Flexibility Should Not Be Considered Swaps Or Commodity Options.}

AGA seeks clarification that the types of physical, peaking gas supply contracts prevalent in the energy industry are intended to be physically settled such that they would not be considered “swaps” or “commodity options” notwithstanding the fact that such contracts contain certain flexibility as to the volumetric delivery terms. As more fully set forth in its July 22, 2011 comments in the Products Definition proceeding, AGA believes that these transactions are physical contracts the purpose of which is to transfer ownership of the commodity and not to transfer solely its price risk. The flexibility to elect up to a specific maximum volume of natural gas to be delivered under such peaking supply contracts is a function related to operational (not financial) concerns, such as the variability of weather conditions and the need for gas utilities to be able to ensure the delivery of the amount of physical gas supplies they need on the days when their customer demand is highest, and/or as other system operational needs dictate. Accordingly, these transactions are a common and critically important component of a gas utility’s natural gas supply portfolio to ensure the gas utility can meet its customers’ needs during peak periods. Such transactions have traditionally fallen outside the Commission’s regulatory jurisdiction and should continue to do so.

Whether in this proceeding or in the Products Definition proceeding, AGA urges the Commission to clarify that peaking supply transactions are not subject to regulation either as

\textsuperscript{12} \textit{Id.} at p. 26,329.
swaps or commodity options. Further, the AGA respectfully requests that the Commission address this issue quickly. Gas utilities are currently in the market arranging to meet the gas supply needs of their retail customers for the upcoming winter heating season from November 2012 to March 2013. As a result, gas utilities and their suppliers need certainty as to whether peaking supply contracts will be subject to the Commission’s regulations.

2. As An Alternative, AGA Supports A Modified Trade Option Exemption.

In the alternative, to the extent the Commission believes that physical, peaking supply contracts with flexibility as to the delivery terms should be regulated, AGA believes that such transactions should be subject to less stringent regulatory requirements under the proposed trade option exemption, as further modified consistent with these comments. Unless modified, the proposed trade option exemption would remain problematic for the types of transactions in which gas utilities engage.

Because peaking supply contracts are physical transactions, the gas suppliers offering such transactions are unlikely to be swap dealers or major swap participants already subject to the reporting requirements of Part 45 of the Commission’s regulations. As a result, both gas utilities and their gas suppliers would be required to comply with the recordkeeping and reporting requirements of Part 45 with respect to these transactions. These requirements would be onerous for gas utilities. Physical, peaking supply contracts are typically negotiated by procurement professionals in the utility’s gas supply group. That function is usually separate from the utility’s risk management or financial market trading group. Consequently, the utility may need to employ two separate recordkeeping and reporting regimes.

Moreover, the reporting requirements under Part 45 of the Commission’s regulations may conflict with other reporting requirements applicable to the gas supply procurement function.
For example, the Federal Energy Regulatory Commission ("FERC") has required all natural gas market participants, with some exceptions, to report annually information regarding wholesale, physical, natural gas transactions.\(^\text{13}\) As part of that physical natural gas reporting regime, FERC has clarified that for peaking supply contracts with flexible delivery terms, only the volumes of natural gas that actually flowed under the contract are required to be reported.\(^\text{14}\) In other words, volumes not taken under a peaking supply contract are not required to be reported. Under this Commission’s Part 45 regulations, it appears that for peaking supply contracts, the entire volume contracted for (regardless of what volumes actually flowed) would be required to be reported. As a result, gas utilities may be required to report one set of volumes to this Commission and a different set of volumes to the FERC with regard to the same transactions. The differing reporting requirements may thus lead to confusion and mistakes.

The Commission’s proposal specifies that if a counterparty is already reporting other (non-trade options) swaps under Part 45 reporting, it must continue to be the reporting entity for Part 45 reporting of trade options. AGA is concerned that a gas utility may be required to comply with all of the Part 45 reporting requirements regarding trade options because it may have had to report other swaps, e.g., the gas utility may be required to report an end-user to end-user pre-enactment or transition swap. AGA believes that the requirement to report historic swaps should not subject an end-user to the full Part 45 reporting requirements with respect to trade options. In many cases, end-users would not have the necessary systems in place to


comply with all of the reporting requirements. In addition, the Commission should continue to look to swap dealers and major swap participants for reporting of transactions, including trade options. Accordingly, AGA recommends that the Commission modify its proposal such that gas utilities and other non-swap dealers or major swap participants would not be required to comply with the Commission’s Part 45 reporting requirements even with respect to their trade options transactions, notwithstanding the fact that they may have been required to report pre-enactment or transition swaps. AGA contends that such entities should only be required to report their trade option transactions annually on new Form TO. An annual filing requirement would more than satisfy any need for transparency, especially with regard to natural gas peaking supply contracts.

Further, under the Commission’s proposal, trade options would be subject to position limits and large trader reporting. It is uncertain whether peaking supply contracts would be exempt from the position limits as hedging. Consequently, gas utilities may be required to treat physical, peaking supply contracts as positions for purposes of the position limits. As noted above, the risk management and gas supply procurement functions are typically separate in a gas utility. Thus, requiring a gas utility’s gas supply group to manage physical, peaking supply contracts as positions and to coordinate such positions with the risk management group for purposes of managing position limits would be unduly burdensome. Accordingly, AGA recommends that the Commission modify its proposal to eliminate the requirement that end-users abide by position limits and large trader reporting rules with regard to their trade options transactions.

Finally, the Commission sought comment on whether there should be a de minimis threshold below which Part 45 reporting would not apply to a trade option transaction and its non-swap dealer or major swap participant counterparties. AGA supports such a de minimis
threshold and encourages the Commission to set the threshold high enough to exempt reporting under Part 45 of physical, peaking supply contracts. AGA encourages the Commission to work with the natural gas industry to develop the appropriate metric for a *de minimis* threshold related to natural gas trade options transactions. For example, a large gas utility may enter into peaking supply contracts that provide the gas utility with the flexibility to take delivery of up to 200,000 MMBtu per day during the winter heating season. The total volume of such contracts would equal 30.2 million MMBtus on an annual basis (200,000 MMBtu/day x 151 days during the winter heating season [November 1 through March 30] = 30,200,000 MMBtus). Accordingly, AGA respectfully requests that the Commission modify its proposal to include a *de minimis* threshold below which a person would not have to comply with the Part 45 reporting requirements related to trade options, and to work with the natural gas industry to develop that threshold.

**IV. CONCLUSION**

In sum, the American Gas Association believes that physical, peaking supply transactions should not be subject to regulation by the Commission either as “swaps” or as “commodity options.” For the reasons stated above, AGA respectfully requests that the Commission clarify quickly in either this proceeding or in the proceeding to define the term “swaps” that the types of peaking gas supply contracts prevalent in the energy industry are intended to be physically settled such that they would not be considered “swaps” or “commodity options” notwithstanding the fact that they contain certain flexibility as to the delivery terms. In the alternative, to the extent the Commission believes that physical, peaking supply contracts with flexibility as to the delivery terms should be regulated, AGA believes that such transactions should be subject to less stringent regulatory requirements than have been proposed under the trade option exemption, as
discussed more fully above. In particular, AGA recommends that the Commission modify its proposal such that gas utilities and other non-swap dealers or major swap participants would not be required to comply with the Commission’s Part 45 reporting requirements with respect to their trade options transactions; rather, such entities should only be required to report their trade option transactions annually on new Form TO.

Respectfully submitted,

/s/ Andrew K. Soto

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July 26, 2012
ATTACHMENT A
March 23, 2012

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


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

Enc.
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

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

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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](http://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.\(^4\)

\[^4\text{The five-month period from November through March is commonly referred to in the natural gas industry as the winter season.}\]
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.
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 contacts 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

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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.\(^\text{10}\) 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.\(^\text{11}\)

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 contact 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.\(^\text{12}\)

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 principles; (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). The Commission proposed to withdraw its Energy Exemption, while retaining and extending the Brent Interpretation to non-financial commodities.

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. 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. 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. 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. 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 contact as a

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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.*
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.

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

\[ \text{Id.} \]

\[ \text{Id.} \]
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.


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).
predominant feature of the contract cannot be actual delivery, and the embedded option
precludes treatment of the contract as a forward contract.\textsuperscript{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.

\textsuperscript{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

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, 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. 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).
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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