



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Swap Dealer
and Intermediary Oversight

Gary Barnett
Director

CFTC Letter No. 14-96
No-Action
July 25, 2014
Division of Swap Dealer and Intermediary Oversight

Re: "A" and affiliates request for exemption of Production Payment Vehicles from commodity pool regulation

Dear :

This letter is in response to your letter dated June 18, 2014, to the Division of Swap Dealer and Intermediary Oversight (the "Division") of the Commodity Futures Trading Commission (the "Commission"), as well as additional email correspondence with Division staff. You request on behalf of "A" and its swap dealer affiliates (collectively, "B") confirmation that the Division would not recommend enforcement action against "B" for its roles as commodity pool operator and/or commodity trading advisor of "volumetric production payment vehicles" ("VPP Vehicles") for failure to register as such.

Based upon the representations in your letter, we understand the relevant facts to be as follows. VPP Vehicles are oil and gas financing structures used by U.S. oil and natural gas producers which execute swaps to hedge market risks of a physical commodity production payment asset that they own and interest rate exposure enabling them to service any fixed income securities that the vehicle may issue. Because of the inclusion of swaps as a commodity interest within the definition of a commodity pool under Section 1a(10) of the Commodity Exchange Act, such vehicles may be classified as commodity pools.

You describe VPP Vehicles as special purpose entities that own passive, non-operating, overriding royalty interests in oil and natural gas well production that entitle their owner to receive delivery of a certain volume or value of liquid or gaseous hydrocarbons, typically each month, for a specified period of time, determined without regard to production costs. Stated another way, the oil or natural gas company (the "Seller") conveys the right to receive production from the subject wells that are identified in the conveyance up to an agreed upon volume or value. You state that the production payment vehicle issues debt or debt-like instruments, which are fixed income securities, the proceeds of which it uses to acquire the royalty interests from the Seller. Alternatively, the VPP Vehicle may be financed via a syndicated loan. You also state that the vehicle receives and immediately sells the hydrocarbons received by it each month under the production payment at a then-market price. You state that the transaction is structured such that the scheduled production volumes delivered would generate cash proceeds, if sold at market prices in existence on or around the execution date of the conveyance, sufficient to repay the issued securities. In the event that there is a shortfall in the scheduled production delivery, you state that a cash calculated make-up amount

accrues, which is based on the market price for that delivery period, and to the extent that there is excess production in subsequent months, the Seller must provide make-up volumes sufficient in volume at then current market prices for that future delivery period to satisfy that make-up amount.

Additionally, you also state that concurrent with the acquisition of the production payment, the production payment vehicle enters into swaps to hedge its commodity market risk related to the sale at market price of the physical hydrocarbon production and the interest rate exposure enabling it to service the fixed income securities. You state that the production payment vehicle does not trade in and out of swaps to generate profits or mitigate losses. You also state that the Commission has previously recognized that a production payment vehicle's commodity swaps would qualify as bona fide hedges for purposes of position limits.¹

Based on the representations in your correspondence, the Division will not recommend that the Commission take enforcement action against "B" in its role as commodity pool operator of a VPP Vehicle for failure to register as such, provided that the VPP Vehicle's use of swaps satisfies the following conditions:

1. The swap(s) will have the effect of reducing risk relative to the risk of the unhedged position;
2. The swap(s) position cannot be established, held, altered or terminated for the purpose of seeking to generate investment income;
3. The swap(s) will only hedge risks inherent in the physical assets of, or the fixed income securities issued by, the VPP Vehicle and not risks arising from the arrangement by which the assets are held or financed;
4. The hedged physical asset and its cash flows, without benefit of the swaps or other hedging transactions, would provide at least an investment grade likelihood² of paying and retiring the VPP Vehicle's securities in accordance with their terms;
5. The swap(s) will not introduce any new risks to the VPP Vehicle other than counterparty risk arising from the swap(s); and
6. The terms and conditions of the swap(s) are consistent with those generally available in the non-structured, traditional swaps market; and
7. The seller or sponsor will have employed reasonable risk management policies and procedures to reasonably ensure compliance with the terms of this letter.³

Based upon the facts provided to the Division in your correspondence, you have represented that the swaps engaged in by the VPP Vehicles satisfy the aforementioned conditions.

¹ Position Limits for Derivatives, 78 Fed. Reg. 75680, 75837 (proposed Dec. 12, 2013).

² This may be derived through internal rating processes which are executed consistent with reasonable risk management policies and procedures.

³ This relief is consistent with that provided by the Division in CFTC Staff Letter 13-88.

Additionally, the Division believes that granting no-action relief with respect to registration as a commodity trading advisor is also warranted. In particular, the Division notes that the advisory activities are limited in nature and are provided to an entity whose commodity pool operator, based on the representations made in the Correspondence, has been granted no-action relief by this Division with respect to its related activities pursuant to the terms of this letter. Accordingly, the Division will not recommend that the Commission take an enforcement action against “B” for failure to register as a commodity trading advisor pursuant to Section 6m of the Act and Commission regulation 3.4 in connection with its advisory activities in respect of the VPP Vehicles as they have been presented in the Correspondence.⁴

This letter, and the positions taken herein, represent the view of this Division only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission. The relief issued by this letter does not excuse the affected persons from compliance with any other applicable requirements contained in the Act or in the Commission’s regulations issued thereunder. This letter does not create or confer any rights for or obligations on any person or persons subject to compliance with the Commodity Exchange Act that bind the Commission or any of its other offices or divisions. Further, this letter, and the relief contained herein, is based upon the representations made to the Division. Any different, changed or omitted material facts or circumstances might render this letter void.

Should you have any questions, please do not hesitate to contact the undersigned at 202-418-5977 or Amanda Olear, Associate Director, at 202-418-5283.

Very truly yours,

Gary Barnett
Director
Division of Swap Dealer
and Intermediary Oversight

⁴ Nothing in this letter should be construed as providing any relief or opinion with respect to any other activities in which “B” may engage.