



# Commodity Futures Trading Commission

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## Office of General Counsel (“OGC”) Response to Frequently Asked Questions Regarding Certain Physical Commercial Agreements for the Supply and Consumption of Energy

***In Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping<sup>1</sup> (the “Adopting Release”), the Commission included an interpretation (“Interpretation”) regarding certain physical commercial agreements for the supply and consumption of energy that provide flexibility, such as tolls on power plants, transportation agreements on natural gas pipelines, and natural gas storage agreements. The Commission stated that it will interpret an agreement, contract or transaction not to be a commodity option if three elements are satisfied: (1) the subject of the agreement, contract or transaction is usage of a specified facility or part thereof rather than the purchase or sale of the commodity that is to be created, transported, processed or stored using the specified facility; (2) the agreement, contract or transaction grants the buyer the exclusive use of the specified facility or part thereof during its term, and provides for an unconditional obligation on the part of the seller to grant the buyer the exclusive use of the specified facility or part thereof; and (3) the payment for the use of the specified facility or part thereof represents a payment for its use rather than the option to use it.<sup>2</sup> As with the interpretation regarding forwards with embedded options generally contained in the Adopting Release,<sup>3</sup> in evaluating whether flexible physical commercial agreements that meet the three-part test qualify for the forward exclusions, the Commission stated that it will look to the specific facts and circumstances of the agreement, contract or transaction as a whole to evaluate whether the agreement, contract or transaction qualifies for the forward exclusions from the definitions of the terms “swap” and “future delivery.”<sup>4</sup>***

The Commission continued:

However, in the alternative, if the right to use the specified facility is only obtained via the payment of a demand charge or reservation fee, and the exercise of the right (or use of the specified facility or part thereof) entails the further payment of actual storage fees, usage fees, rents, or other analogous service charges not included in the demand charge or reservation fee, such agreement, contract or transaction is a commodity option subject to the swap definition.<sup>5</sup>

After publication in the Federal Register, several commenters expressed the concern that the “however paragraph” could have the unintended consequence of causing certain physical commercial agreements to be considered commodity options, and

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<sup>1</sup> 77 FR 48208 (August 13, 2012).

<sup>2</sup> Id. at 48242 (emphasis added).

<sup>3</sup> Id. at 48237-38.

<sup>4</sup> Id. at 48242.

<sup>5</sup> Id. OGC understands that practitioners colloquially refer to this paragraph as “the ‘however’ paragraph.” See, e.g., letter dated Oct. 10, 2012 from the Texas Pipeline Association at 4, available on the Commission’s website at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58874&SearchText=>.

thus not eligible for the forward exclusion for nonfinancial commodities from the swap definition.<sup>6</sup> In this regard, commenters expressed the view that “the ‘however’ paragraph” suggests that every facility usage contract that entails separate payments for both fixed costs (e.g., a demand charge or reservation fee) and variable costs (e.g., storage fees, usage fees or rents) is an option subject to regulation under the Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>7</sup> Commenters asserted that such a two-part fee structure is the standard fee structure for a wide variety of usage contracts, including interstate transportation of natural gas, which is regulated by the Federal Energy Regulatory Commission (“FERC”).<sup>8</sup>

In OGC’s view, the “however paragraph” was not intended to apply to agreements, contracts or transactions in which the buyer pays for a commodity in two parts, paying the seller’s fixed/known costs upfront and the seller’s variable costs associated with that commodity later once those costs are established or incurred. Commenters have advised OGC that the price of the physical service covered by a wide variety of usage contracts is bifurcated into fixed components that typically track fixed costs<sup>9</sup> (“Demand Charge/Reservation Fee”) and variable components that typically track variable/use-related costs (“Usage Fee”).<sup>10</sup> Commenters also have explained that the Demand Charge/Reservation Fee is a payment in advance for a physical service, not a payment for the right to later obtain a physical service if the buyer chooses to obtain such service.<sup>11</sup>

In OGC’s view, if (1) a facility usage agreement, contract or transaction discussed herein includes a two-part fee structure, (2) the right to use the specified portion of the facility for the term of the agreement, contract or transaction is legally established upon entering into the agreement, contract or transaction, (3) the party who has legally established the right to use the specified portion of the facility for the term of the agreement, contract or transaction pays the Demand Charge/Reservation

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<sup>6</sup> Several market participants also have inquired whether usage of a specified facility for the creation, transportation, processing or storage of a commodity could be considered a “nonfinancial commodity” such that an agreement, contract or transaction involving such usage that did not satisfy the three elements of the Interpretation would be eligible for the Commission’s trade option exemption in Commission regulation § 32.3, 17 CFR § 32.3. Consistent with the Commission’s interpretation in the Adopting Release regarding forward contracts in nonfinancial commodities, 77 FR at 48232-33 (“Nonfinancial Commodities Interpretation”), OGC believes that such usage of a specified facility may constitute a nonfinancial commodity for the following reasons. The Commission’s Nonfinancial Commodities Interpretation states that a nonfinancial commodity is an exempt or agricultural commodity that can be physically delivered. *Id.* at 48232. See also Commodity Options, 77 FR 25320, 25326 (April 27, 2012) (exempt or agricultural commodities that can be physically settled are eligible for the trade option exemption). The usage of a specified facility is not an excluded or agricultural commodity; therefore, it is an exempt commodity. See section 1a(20) of the Commodity Exchange Act (“CEA”), 7 U.S.C. 1a(20) (definition the term “exempt commodity”); see also CEA section 1a(19) (definition the term “excluded commodity”); Commission regulation § 1.3(zz) (definition the term “agricultural commodity”). In certain circumstances, services may be a commodity. See CEA section 1a(9), 7 U.S.C. 1a(9) (definition of a commodity). When the buyer of transportation, processing, storage or creation (e.g., power generation) services creates, transports, processes or stores an agricultural or exempt commodity (e.g., natural gas or electricity), in OGC’s view, that service may thereby be physically delivered to the buyer for purposes of Commission regulation § 32.3(a)(3), 17 CFR 32.3(a)(3) (i.e., the physical settlement element of the trade option exemption).

<sup>7</sup> See, e.g., letter dated Aug. 23, 2012 from ConocoPhillips Company (“ConocoPhillips Letter”) at 7, available on the Commission’s website at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58427&SearchText>.

<sup>8</sup> Examples of other agreements that are often structured with this two-tiered fee approach include tolling agreements for electricity generation, storage, re-gasification of imported liquefied natural gas, marine vessel chartering, and terminal arrangements. *Id.* Commenters have advised OGC that a return on investment often is included in the demand charge or reservation fee. October 2012 OGC communication with David Perlman, Bracewell & Giuliani.

<sup>9</sup> Commenters have advised OGC that sometimes physical service covered by a usage contract includes an embedded profit, which sometimes is approved by federal or state regulators. *Id.*

<sup>10</sup> Letter dated October 9, 2012 from the Interstate Natural Gas Association of America at 8 (Request for Clarification and No-Action Relief Regarding Commission Interpretive Guidance on Transportation and Storage Agreements with Two-Part Fee Structures Set Forth in the Commission’s Swap Definition Final Rule) (“INGAA Letter”), available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58908&SearchText=INGAA> (stating that “the usage fee is in the nature of a reimbursement for the variable costs incurred by the operator in rendering the service”).

<sup>11</sup> *Id.* (stating that “[t]he right to use the specified amount of capacity for the term of the agreement is legally established upon signing the agreement, and the use of the facility does not depend on the further exercise of an option[.]”).

Fee in a commercially reasonable timeframe,<sup>12</sup> (4) the use of the facility does not depend on the further exercise of an option and (5) the Usage Fee is in the nature of a reimbursement for the variable costs incurred by the operator of the facility in rendering the service, such a facility usage agreement, contract or transaction is not an option and is not intended to be covered by the “however paragraph.”<sup>13</sup> A facility usage agreement, contract or transaction with a two-part fee structure that fails to meet one or more of the conditions above may<sup>14</sup> or may not be an option. Whether such an agreement, contract or transaction is an option depends on the specific facts and circumstances of the agreement, contract or transaction as a whole.

The views expressed in this response to frequently asked questions represent only those of OGC and do not necessarily reflect the views of, and do not bind, the Commission or any other office or division within the Commission, any Commissioner, or any other Federal regulatory agency. OGC reminds market participants that even if an agreement, contract or transaction is a forward, not an option, it is not wholly excluded from the CEA or the Commission’s regulations for all purposes.<sup>15</sup> Nothing herein is applicable to agreements, contracts, or transactions that are “security-based swaps” or “mixed swaps.”

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<sup>12</sup> Absent evasion, OGC would view a commercially reasonable timeframe to be the appropriate usage of trade or the parties’ normal course of dealing.

<sup>13</sup> Accord INGAA Letter.

<sup>14</sup> For example, the Edison Electric Institute’s form of Master Power Purchase & Sale Agreement (“EEI MPPSA”) contains provisions defining options generally (see EEI MPPSA section 1.34 (defining an option as “the right but not the obligation to purchase or sell a Product as specified in a Transaction.”)) and also specifically defining a “Call Option” and a “Put Option,” in each case related to power or other energy-related products. In OGC’s view, if an agreement, contract or transaction to provide physical commodity creation, transportation, processing or storage service includes a payment of a premium for the “entitle[ment]” such as described in the Call Option and Put Option definitions in the EEI MPPSA (i.e., the right to buy or sell, as the case may be, a physical commodity, which commodity could be creating, transporting, processing or storing an agricultural or exempt commodity that can be physically delivered) rather than payment for the commodity, it is likely to be a commodity option within the CFTC’s jurisdiction.

See CEA sections 1a(47)(A)(i)(defining options as swaps) and 1a(47)(A)(iv)(defining as a swap an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap). OGC also notes that this is just an example of an option on a service, rather than the outer bounds of the CFTC’s authority over options. Thus, market participants should be cognizant, when developing new products, of CEA sections 1a(47)(A)(iv) and 1a(47)(A)(vi)(defining as a swap any combination or permutation of, or option on, any agreement, contract, or transaction described in any of the first five prongs of the statutory swap definition). See also EEI MPPSA sections 1.6 and 1.48. Section 1.6 defines a “Call Option” as:

an Option entitling, but not obligating, the Option Buyer to purchase and receive the Product from the Option Seller at a price equal to the Strike Price for the Delivery Period for which the Option may be exercised, all as specified in the Transaction. Upon proper exercise of the Option by the Option Buyer, the Option Seller will be obligated to sell and deliver the Product for the Delivery Period for which the Option has been exercised.

Section 1.48 defines a “Put Option” as:

an Option entitling, but not obligating, the Option Buyer to sell and deliver the Product to the Option Seller at a price equal to the Strike Price for the Delivery Period for which the option may be exercised, all as specified in a Transaction. Upon proper exercise of the Option by the Option Buyer, the Option Seller will be obligated to purchase and receive the Product.

<sup>15</sup> In that regard, see Adopting Release at 48,229, n.226 (describing the CFTC’s residual anti-fraud, anti-manipulation and other authority over forwards).