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Re: Response of the International Energy Credit Association ("IECA") to Commodity Futures Trading Commission ("CFTC") Notice of Proposed Rule ("NOPR") respecting Further Definition of "Swap," "Security-Based Swap," etc., (17 CFR Part 23, RIN 3038-AC96, 76 Federal Register 29818, May 23, 2011) pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Ladies and Gentlemen:

The CFTC by the above-referenced NOPR requests public comment on the proposed rule and other matters. This letter responds to the NOPR.

I. Introduction.

IECA is the leading global organization focused on credit-related issues in the energy industry. It was founded in 1923. The IECA and its members have wide and deep expertise and experience in developing improved metrics, documentation, and tools to assess, manage, and mitigate credit risk. Its members come from more than 500 companies, representing every facet of the energy complex from producers and processors to generators, transporters and end-users. Most of these companies execute privately negotiated over-the-counter derivatives in commodities, interest rates, or currencies.

Derivatives are essential to the business of many of these companies, as well as their suppliers, customers and counterparties. Among other things, derivatives are used to:

- Protect against increases in costs;
- Protect against a decline in the value of inventory;
- Manage cash flow, working capital, and liquidity;
- Maximize the value of assets;

- Meet the needs of customers; and,
- Comply with the terms of financing arrangements, which frequently require hedging of interest rate, foreign exchange, and commodity price risk to ensure the borrower's ability to pay its debt.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") will have an enormous impact on working capital requirements, the costs of hedging, and earnings volatility - all critical credit-related issues.

In view of these concerns, the IECA, for the first time in its almost ninety-year history, is commenting in a series of rule-making proceedings. The purpose of these comments is to shape the rules in a way that will achieve more certainty for market participants, maximize the potential for bilateral credit relationships, limit the scope of mandatory clearing, and preserve as much competition and flexibility as possible.

Correspondence with respect to these comments should be directed to the following individuals:

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II. Comments on the Proposed Rules.

The CFTC seems to assert in this NOPR, through a number of mechanisms discussed below, that all transactions for the purchase and sale of goods and services that do not fit within certain limited exceptions are "swaps" subject to its jurisdiction, and provides a fuzzy interpretive guidance outside of the rule itself to side-step the implications of the scope of the jurisdiction it has asserted. This jurisdiction over almost all aspects of the American economy that the CFTC seems to assert is of a size and scale unprecedented outside of 1917-18 and 1941-45. In those crisis years, there was a major global war that potentially jeopardized the existence of democracy, and Congress had granted the jurisdiction exercised by government agencies. Neither of those conditions are present with respect to Dodd-Frank or the jurisdiction asserted by the CFTC thereunder.

Members of the IECA play leading roles in this country's energy supply chain. They therefore offer the perspective of a very "real" sector of the economy. Even though energy had nothing to do with the 2008 financial crisis that precipitated Dodd-Frank, these comments do not ask that the rules not be applied to the "real" economy on that basis. Rather, these comments, from people who want to comply with the law and the rules, simply suggest that enforcement ultimately would be best served by rules that (a) explicitly describe required and prohibited behaviors and (b) are confined to the authority granted by Congress.

1. <u>The "Customary Consumer or Commercial Arrangements" Exemption Asserts Extremely Broad Jurisdiction</u>

The purpose of Dodd-Frank is to regulate swaps and swap dealing. The purpose of Dodd-Frank is not to grant to the CFTC regulation of the nation's economy. Nevertheless, this is what the NOPR asserts for the CFTC by pulling into its jurisdiction essentially all commercial and individual transactions and then exempting broad swaths of the economy from CFTC regulation by a vague "interpretive guidance," rather than in the rules themselves.

The NOPR provides:

> The types of commercial agreements, contracts, or transactions that involve customary business arrangements (whether or not involving a for-profit entity) and would not be considered swaps or security-based swaps under this proposed interpretive guidance include: …. The purchase, sale, lease, or transfer of real property, intellectual property, equipment, or inventory; … [1]

The NOPR goes on to say:

> …applying this guidance to customary commercial arrangements should allow commercial and non-profit entities to continue to operate their businesses and operations without significant disruption and ensure that the swap and security-based swap definitions are not read to include commercial and non-profit operations that historically have not been considered to involve swaps or security-based swaps. The types of agreements, contracts, and transactions discussed above are not intended to be exhaustive of the customary consumer or commercial arrangements that should not be considered to be swaps or security-based swaps. There may be other, similar types of agreements, contracts, and transactions that also should not be considered to be swaps or security-based swaps. … This proposed interpretive guidance is not intended to be the exclusive means for consumers and commercial or non-profit entities to determine whether their agreements, contracts, or transactions fall within the swap or security-based swap definition. If there is a type of agreement, contract, or transaction that is not enumerated above, or does not have all the characteristics and factors that are listed above (including new types of arrangements that may be developed in the future), but that a party to the agreement, contract, or transaction believes is not a swap or security-based swap, the Commissions invite such party to seek an interpretation from the Commissions as to whether the agreement, contract, or transaction is a swap or security-based swap.[2]

The CFTC then asks:

> Is the treatment of consumer or commercial contracts containing payment arrangements sufficiently clear? For example, should the interpretive guidance expressly address any other specific types of contracts, such as installment sales contracts, financings used in

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[1] p. 29833 col. 1.
[2] p. 29833 col. 2.

> normal business operations (such as receivables financings), pensions and other postretirement benefits, contracts relating to the performance of a service, standby liquidity agreements, indemnification agreements, reimbursement agreements, or affiliate guarantees? Why or why not? … Is the treatment of purchases, sales, leases, or transfers of equipment and inventory sufficiently flexible to not interfere with ordinary business operations? As an alternative, should the guidance expressly cover the purchase, sale, lease, or transfer of assets (excluding financial assets) that are anticipated to be owned, leased, licensed, produced, manufactured, processed, or merchandized by one of the parties or an affiliate? Why or why not?[3]

Reading these provisions together, the NOPR implicitly asserts CFTC jurisdiction over all commercial and consumer transactions. By using this interpretive guidance mechanism, the CFTC implies that exemptions from this extremely broad jurisdiction are granted by the CFTC in interpretive guidances. And while the interpretive guidance suggests exemptions from its jurisdiction, those exemptions are then questioned by the CFTC elsewhere in the NOPR.

The CFTC should forthrightly state that it does not claim such jurisdiction in the text of the rules themselves, rather than through an "interpretive guidance." The NOPR says "If there is a type of agreement … not enumerated above, or [without] all the characteristics and factors that are listed above (including new types of arrangements that may be developed in the future), … the Commissions invite such party to seek an interpretation … as to whether [it] is a swap."[4]

The IECA submits that all actors in the economy should not be required to petition the CFTC for exemptions for their commercial and individual transactions. The CFTC has been granted jurisdiction only over "swaps," and not been given the right to determine that any transaction that it wishes to call a "swap" is under its jurisdiction, even if that transaction is not an exchange of cash flows. Therefore, the rule simply should say:

> **Any agreement or arrangement to exchange money for something that is not money is not a "swap."**

2. The CFTC's Interpretation of "Commodity Options" Has Profound Implications for Federalism

We recognize that the CFTC wishes to be sure that its rules enforce the requirements of Dodd-Frank and ensure that current swap market participants cannot simply restructure their swap transactions to remove systemically risky transactions from CFTC oversight. However, we believe that the CFTC can accomplish the goals of Dodd-Frank without capturing the entire economy, as proposed in this NOPR.

The NOPR provides: "where the embedded commodity option(s) render delivery optional, the predominant feature of the contract cannot be actual delivery and, therefore, the embedded option(s) to not deliver preclude treatment of the contract as a forward contract for a

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[3] p. 29834 col. 1.
[4] P. 29833 col. 2 (emphasis supplied).

nonfinancial commodity."[5] The NOPR does <u>not</u> provide: "where the embedded commodity option(s) render delivery optional, <u>with financial settlement instead of delivery,</u> the predominant feature of the contract cannot be actual delivery … ."

Accordingly, the words of the NOPR reach far beyond the ordinary concept of financial settlement in place of a contracted delivery, to capture any contract where delivery itself is optional. One could provide for an option to financially settle a required delivery. There could be circumstances where such a contract is a swap, although perhaps the regulations concerning such contracts are already captured in CFTC regulations respecting off-exchange futures contracts. But the NOPR language goes beyond this to claim that an option on whether or not to deliver at all- in other words, an option on the <u>volume</u> of commodities to be delivered under the contract- creates a swap. The proposed interpretive guidance does not carve volume optionality out from deliverability optionality.

Since a large swath of American commerce, from consumption of electricity by an aluminum mill to purchase of microchips by a computer manufacturer, are pursuant to bilateral contracts entered into on a "full requirements" basis that leaves the volume quantity actually delivered "optional," and based on needs to be determined later rather than a fixed quantity, the rule as written in the NOPR would subject that part of American commerce to the jurisdiction of the CFTC as "swaps" under Dodd-Frank.

The NOPR also provides that a forward contract cannot "target the delivery term".[6] This would mean that commodity contracts with evergreen or extension terms, which are quite common (for example, a five year power purchase agreement with a one year renewal term), would be regulated by the CFTC as "swaps".

To avoid the risks of having their ordinary purchasing practices regulated by Dodd-Frank, companies would have to change them, and enter into fixed quantity and fixed term transactions rather than full requirements contracts, reducing their commercial flexibility, and increasing price and risk throughout the economy. The greater the extent to which the "real" economy is captured by the regulations, the greater the unintended consequences. The uncertainty of the NOPR's proposed rules would create far bigger problems for the "real" economy than the swap risks Dodd-Frank sought to address.

Additionally, this broad assertion of CFTC jurisdiction would pre-empt significant aspects of state and federal law concerning the purchase and sale of goods and services. Federal courts would be burdened with what would otherwise have been state contract law disputes regarding any contract that is not for a fixed quantity and fixed term now having a federal question. A CFTC requirement that all swap transactions be in writing would federally pre-empt all state laws concerning oral agreements for full requirement contracts.

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[5] p. 29830 col. 2.
[6] p. 29830 col. 2.

Coupled with the CFTC's proposed right for itself in the anti-evasion rules[7] to federalize any transaction by redefining it as a "swap," even if not in the 1a47(A) statutory definition of "swap," the NOPR has profound implications for federalism.

Even if the CFTC agrees to exempt the specific type of transaction from its rules, asserting jurisdiction while providing an exemption means that the CFTC could change its mind about the exemption later. Congress intended to regulate swaps, which Congress defined. Congress did not intend to federalize the economy by Dodd-Frank.

3. <u>The "Customary Consumer or Commercial Arrangements" Exemption is Vague</u>

The dividing line between an ordinary commercial transaction and a forward transaction subject to or exempt from the definition of "swap" set forth in the "Customary Consumer or Commercial Arrangements" "interpretive guidance" is not clear. Is an aluminum manufacturing plant taking all of its energy requirements from an energy company entering into a customary commercial transaction or a physical forward that is not exempt because it includes an embedded "commodity option" due to an unfixed quantity? For example, the "interpretive guidance" quoted above is contradicted elsewhere in the NOPR when the CFTC asks:

> Should a minimum contract size for a transaction in a nonfinancial commodity (*e.g.,* a tanker full of Brent oil) be required in order for the transaction to qualify as a forward contract under the Brent Interpretation with respect to the future delivery and swap definitions? Why or why not?[8]

This would appear to say that instead of a minimum below which the swap definitions will not apply, there is a minimum below which the swap definitions <u>will</u> apply.

The IECA reminds the CFTC that CEA §1a47(B)(i) provides: "[t]he term 'swap' does not include— (i) any contract of sale of a commodity for future delivery (or option on such a contract) …" Accordingly, the CFTC should simply explicitly state in its regulations that it is not regulating forward commodity sale agreements or options on forward agreements.

4. <u>The Exception Does Not Swallow The Rule</u>

CEA §1a47(A) says "Except as provided in subparagraph (B), the term 'swap' means any agreement, contract, or transaction—" and lists a number of types of transactions that are "swaps". CEA §1a47(B) says "[t]he term 'swap' does not include: '(i) any contract of sale of a commodity for future delivery (or option on such a contract), …; (ii) any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled; … ."

The CFTC implies that it may designate any transaction not within the exception (1a47(B)) as within the meaning of the rule of 1a47(A), even if it is not listed in the rule

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[7] NOPR Section VII; discussed in detail below.
[8] p. 29831 col. 3.

(1a47(A)).[9] The CFTC also suggests that it may place within its jurisdiction under Dodd-Frank a transaction that is not within meaning of the statutory term "swap" by simply designating that transaction a "swap."[10] However, Dodd-Frank did not give the CFTC that authority.

Under Dodd-Frank, for any transaction to be regulated as a "swap," it must first fit within the rule- 1a47(A)- and be a "swap," before it can be required to fit within the exception- 1a47(B)- in order to qualify for an exemption from regulation as a "swap".

5. The Proposed "Anti-Evasion Rule" Asserts Jurisdiction for the CFTC Exceeding What Congress Granted

The CFTC's proposed anti-evasion rule claims the right for the CFTC to turn into a swap any physical transaction, or other transaction that is on its face not a swap:

> (xxx)(6) *Anti-evasion.* (i) An agreement, contract, or transaction that is willfully structured to evade any provision of Subtitle A of [Title VII of Dodd-Frank], shall be deemed a swap for purposes of Subtitle A and the rules, regulations, and orders of the Commission promulgated thereunder. …

However, the operative provision of Title VII of Dodd-Frank that this regulation is intended to implement, CEA §2(h)(4)(A), provides:

> The Commission shall prescribe rules under this subsection (and issue interpretations of rules prescribed under this subsection) as determined by the Commission to be necessary to prevent evasions of the mandatory clearing requirements under this Act.

This means that the CFTC is to prescribe rules "necessary" to prevent evasion of "mandatory clearing requirements." The statute does not say evasions of "any provision" of Dodd-Frank, nor does it say that the CFTC may expand its jurisdiction to include transactions not defined as "swaps" by Congress.

CEA §6(e) provides:

> (4) Any designated clearing organization that knowingly or recklessly evades or participates in or facilitates an evasion of the requirements of section 2(h) shall be liable for a civil money penalty in twice the amount otherwise available for a violation of section 2(h).
>
> (5) Any swap dealer or major swap participant that knowingly or recklessly evades or participates in or facilitates an evasion of the requirements of section 2(h) shall be liable for a civil money penalty in twice the amount otherwise available for a violation of section 2(h).

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9 See e.g. question 32 on p. 29832 col. 1, when the CFTC implies that a commodity transaction can be turned into a swap simply by defining away "physically settled," which is an exception of CEA section 1a47(B), even if the commodity transaction does not fit within CEA section 1a47(A).

10 NOPR part VII.

This means that a civil penalty can be imposed on SDs or MSPs that evade or participate in an evasion of CEA Section 2(h). Congress did not give the CFTC the authority to deem a transaction a "swap" because one party "evaded." Section 1a47(A) does not include within the meaning of the word "swap" a transaction that could have been a swap but is not a swap for reasons considered relevant by the CFTC.

CEA 2(i) provides:

> The provisions of this Act relating to swaps ... shall not apply to activities outside the United States unless those activities ... contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this Act that was enacted by the Wall Street Transparency and Accountability Act of 2010.

The jurisdiction granted by this particular section refers to activities outside of the United States; nothing in this provision grants CFTC jurisdiction over activities within the United States.

6. The Proposed "Anti-Evasion Rule" Punishes the Innocent

In terms of what constitutes "evasion," the CFTC offers a further rule:

> (xxx)(6) (iv) The form, label, and written documentation of an agreement, contract, or transaction shall not be dispositive in determining whether the agreement, contract, or transaction has been willfully structured to evade ….

and notes: "The CFTC emphasizes … that it would examine each individual case on a case-by-case basis, and additional practices or circumstances may warrant a finding that particular conduct or transactions constitute an evasion of the requirements of the Dodd-Frank Act with respect to swaps"[11] and that "any attempt to ... provide a bright-line test of evasion by rule, would likely not be effective as would-be evaders could simply restructure their transactions or entities to fall outside any rigid boundary."[12] The CFTC also notes that "Although deceitful, deceptive, or illegitimate conduct may be sufficient to find that evasion has occurred, such conduct is not a prerequisite for a finding of evasion, particularly when other indicia of evasion are present, such as, for example, when the transaction lacks any business purpose."[13]

The CFTC is therefore stating that anyone who enters into a transaction ("party X") that is not a swap, could find itself a party to a swap, if its counterparty "evaded" Dodd-Frank ("party Y"), even if party X knew nothing of party Y's goals or intent. The CFTC's proposed "anti-evasion rule" establishes a reverse *mens rea* requirement for physical transactions, i.e., both parties would need to enter into a non-swap transaction without any intent to evade any provision of the CFTC's jurisdiction; because failure by either party would render both parties transacting in a swap, even if one party had no reason to suspect the "evading intent" of the other. The

[11] p. 29867 col. 2.
[12] p. 29866 col. 2.
[13] p. 29867 col. 2, fn. 326.

NOPR says "The CFTC believes that looking beyond the form of the transaction to examine its actual substance is necessary to prevent evasion through clever draftsmanship."[14] "Clever draftsmanship" for one party could be the typical contractual terms of a non-swap transaction to the other.

There are two parties to any commodity forward agreement, and each party can only know what is in its own mind. The CFTC's "we'll know it when we see it" standard does not provide notice of the requirements of law sufficient to permit market participants to comply. The problem does not appear solvable with contract representations, as there is no safe harbor for the "innocent" party, and the contents of the document "shall not be dispositive."

The anti-evasion rules have consequences to enforcement of contracts if one side to the transaction claims to be the "innocent" party seeking to enforce violations of Dodd-Frank rules in order to get out of a transaction which it has decided is economically unfavorable, or, the "guilty" party "confesses" its evasive intent if it wants to cancel the unsecured credit it has provided to its counterparty.

The CFTC's likening of the anti-evasion rules to IRS rules on tax evasion[15] illustrates inadequate consideration of the bilateral nature of private contracts. In futures exchanges, there is a public interacting with a heavily regulated single exchange entity that is one party to a great many transactions; a swap is between two parties. In fact, the NOPR says as much: "[the NOPR] approach is consistent with the CFTC's case law in the context of determining whether a contract is a futures contract."[16] The IRS, seeking to assert that there is "evasion" v. "avoidance," is enforcing against just one party, who could be innocent or guilty of evasion. In contrast, in forward physical markets, there are two parties to bilateral agreements.

Without a bright line and objective test, the rules proposed by the CFTC penalize an innocent party by causing that party to be a party to a swap, subject to the swap regulatory and compliance regime, without its prior knowledge or ability to avoid doing so. Accordingly, the anti-evasion rule should be reformulated solely to impact and affect the "evading" party, and not its counterparty, and set forth behavioral guidelines.

7. <u>A Consistent Pattern of Evasion Should be Considered in Determining Status</u>

The IECA agrees in part with the following provision of the anti-evasion rules.

> (v) An agreement, contract, or transaction that has been willfully structured to evade … shall be considered in determining whether a person is a swap dealer or major swap participant.

However, such a rule should be limited to the authorities regarding evasion provided by Congress, require a pattern of transactions, and refer to the entity structuring the evading transactions.

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14 p. 29866 col. 3.
15 p. 29867 col. 3.
16 p. 29866 col. 3.

III. **Responses to Commission Requests in the NOPR**.

1. Options on Forwards.

The CFTC asks:

> Are there other factors that should be considered in determining how to characterize forward contracts with embedded options with respect to nonfinancial commodities?[17]

With respect to all commodities, not just non-financial commodities, a factor to be considered in determining how to characterize forward contracts with embedded options is CEA §1a47(B)(i), which provides:

> (B) EXCLUSIONS.—The term ''swap'' does not include— (i) any contract of sale of a commodity for future delivery (or option on such a contract) … (emphasis supplied).

2. Master Agreements

The CFTC asks:

> What agreements, contracts, or transactions that are not swaps or security-based swaps are documented using industry standard form agreements that are typically used for swaps and security-based swaps? Please provide examples of such agreements, contracts, or transactions and details regarding their documentation, including why industry standard form agreements typically used for swaps and security-based swaps are used.[18]

Trade associations, such as ISDA and the Edison Electric Institute (EEI), have prepared and made available forms of agreement that are not swaps, but use as their framework the ISDA Master Agreement.[19] Even though swaps are commonly documented on the ISDA Master Agreements without annexes, physical transactions under such agreements with power or natural gas annexes are not swaps because they are physically settled forward contracts that are exempt under 1a47(B). It is advantageous to use these master agreements with annexes because one can potentially include thousands of separate transactions between the parties in a single contract, which must be assumed or rejected by a bankrupt entity as one agreement, rather than allow cherry picking each of the transactions. This "netting" process substantially mitigates credit risk.

When a company goes bankrupt, it is allowed under Section 365 of the Bankruptcy Code to assume, or force its counterparty to perform, those agreements it wishes to continue, because they are profitable, and reject, breaking and leaving the non-bankrupt counterparty with an unsecured claim respecting, those transactions it does not wish to perform, because they are not

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17 p. 29832 col. 1.

18 p. 29839 col. 2.

19 See, e.g., ISDA/EEI Power Annex, available at http://www.isda.org/publications/pdf/PowerAnnex-NA.pdf, news release at http://www.isda.org/press/press080703.html.

profitable. This is known as "cherry picking." Since the non-bankrupt party owes 100% of those transactions that are not profitable to it (since they were profitable to, and therefore assumed by, the bankrupt party), but only receives pennies on the dollar for those rejected transactions that are profitable to it (since they were not profitable to, and therefore rejected by, the bankrupt party), the credit exposure of the parties to each other can be minimized by integrating different agreements into a single, unitary agreement that is assumed or rejected in total.

For example, ISDA Master Agreements include potentially thousands of separate swap transactions between the parties in a single contract, which must be assumed or rejected by the bankrupt entity as one agreement, rather than allow cherry picking each of the swap transactions. This "netting" process substantially mitigates credit risk. Over the past ten years, this integration into a single agreement has expanded by the development of "annexes" to the Master Agreement. Energy industry participants commonly enter into natural gas, power and/or emissions annexes under the ISDA Master Agreement to document physical transactions.[20] Under this arrangement, the parties have all of their transactions, financial and physical, done under one Master Agreement. Use of these annexes to Master Agreements and bridging agreements between Master Agreements helps expand the ability of parties to net and enter into agreements with each other.

Many industry participants are concerned that credit exposures in general amongst industry market participants will be increased, which would create broad economic risk counter to the stated goals of Dodd-Frank, were parties required to forego the expanded netting opportunities afforded them by use of documentation that enhances netting and setoff among the numerous physical and financial transactions between them. Such would be the situation if documentation requirements for swaps rendered it impossible or unwise to use master agreements that are used for swaps with commodity transactions, through the use of annexes or bridges.

3. <u>The Energy Exemption and FERC</u>

Section 720(a)(1) of Dodd-Frank provides:

> The Commodity Futures Trading Commission and the Federal Energy Regulatory Commission shall, not later than 180 days after the date of the enactment of this Act, negotiate a memorandum of understanding to establish procedures for— (A) applying their respective authorities in a manner so as to ensure effective and efficient regulation in the public interest … .

In its NOPR, the CFTC sets forth several opportunities for the CFTC and the FERC to apply their respective authorities in a manner so as to ensure effective and efficient regulation in the public interest. For example, the CFTC asks:

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[20] See many other example annexes, including gas, coal, emissions, and oil, and bridging agreements, available at http://www.isda.org/c_and_a/comm_der.html.

> Are there any provisions of the Energy Exemption or Swap Policy Statement that the Commissions should consider incorporating into the definitions rulemakings …? If so, please explain in detail how such provisions are consistent with the requirements of the Dodd-Frank Act and would not permit transactions that should be subject to the swap regulatory regime to fall outside of the Dodd-Frank Act.[21]

There will be energy transactions that will not be swaps even if they do not fit within the Energy Exemption as described in the NOPR,[22] so the Energy Exemption is not the exclusive path for a transaction involving energy to not be a "swap." For example, the Energy Exemption does not appear to include within its terms energy delivered under an electric tariff, since tariffs are not negotiated by both parties, and perhaps not even energy delivered pursuant to regulated standard offered contracts, such as those made available to Qualifying Facilities under the Public Utility Regulatory Policies Act (PURPA) and the FERC's regulations under PURPA. These latter should also not be "swaps."

The IECA submits that the Energy Exemption appears entirely consistent with the provisions of Dodd-Frank, since it provides strictures around the cash settlement of the transaction in lieu of physical delivery for its use as an exemption. Therefore, it should be included within the rules to ensure continued clarity, but specifically noted as a non-exclusive exemption for energy transactions, especially given the profound benefit of certainty in transactions in a key commodity. Development of the remainder of that exemption for energy transactions offers a unique opportunity for FERC and CFTC to work together to develop effective and efficient regulation in the public interest, perhaps as one of the terms of the memorandum of understanding ("MOU") between the CFTC and the FERC mandated by Dodd-Frank.

In the years following the Energy Exemption, the FERC has issued Orders 890 and 890-A[23] defining energy that may qualify as a network resource, with which the energy exemption also appears consistent. In Order No. 890, FERC affirmed that a power purchase agreement (PPA) may be designated as a network resource (NR) under specified circumstances, including the contractual inability to interrupt deliveries for economic reasons,[24] and that a liquidated damages (LD) provision in a PPA did not present an economic settlement option that disqualifies it as a NR.[25] FERC found that the "make whole" LD provisions in EEI's Master Power Purchase and Sale Agreement's Firm LD product (EEI's Firm LD Product) and WSPP's Service Schedule C agreement both satisfied this requirement.[26] "While any party to any contract can choose to fail to perform, that does not convey a contractual right to fail to perform. The EEI contract clearly obligates the supplier to provide power, except in cases of force majeure. Thus, the contract does not allow interruption for economic reasons."[27] In Order No. 890-A, FERC

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[21] p. 29831 col. 2.
[22] p. 29829 col. 2 fn. 72.
[23] *Preventing Undue Discrimination and Preference in Transmission Service*, Order No. 890, 2006-2007 FERC Stats. & Regs., Regs. Preambles ¶ 31,241, *order on reh'g*, Order 890-A, 2006-2007 FERC Stats. & Regs., Regs. Preambles ¶ 31,261 (2007).
[24] *See* Order No. 890 at PP 1452-1461.
[25] *See id.* at PP 1453-1455.
[26] *See id.* at 1455.
[27] *Id.*

affirmed that make-whole LD provisions in the EEI Firm LD Product and the WSPP Service Schedule C agreement are sufficiently firm to make those agreements eligible as NR.[28] This shows a commonality of thinking and approach between CFTC and FERC regulation that can be built upon.

In another part of the NOPR, the CFTC states: "[T]he Commissions are not addressing FTRs or other transactions in RTOs or ISOs within this joint definitional rulemaking. Instead, persons with concerns about whether FERC-regulated products may be considered swaps (or futures) should request an exemption pursuant to section 722 of the Dodd Frank Act."[29] This is another area where efficient regulation in the public interest would be best promoted by FERC and the CFTC working together.

These are just two examples of the many areas respecting energy markets where the CFTC and the FERC could reach common and productive ground in furthering the goals of Dodd-Frank and each of their respective regulatory roles thereunder and under other authorizing legislation. IECA encourages the CFTC to agree to the MOU with FERC as set forth in Section 720 of Dodd-Frank.

4. <u>The IECA Agrees that Book-Outs Are Within the Forward Contract Exclusion</u>

The IECA agrees with the CFTC's analysis[30] that "book outs" are not "swaps." Book-outs represent the necessary intersection of contract markets that are required under FERC and applicable state regulation to be open markets, and the scheduling of physical deliveries of the flowing gas or electricity.

5. <u>Definition of Non-Financial Commodities</u>

The CFTC asks:

> Should the Commissions provide guidance regarding the scope of the term 'nonfinancial commodity' in the forward contract exclusion from the swap definition? If so, how and where should the Commissions draw the line between financial and nonfinancial commodities?"[31]

A good definition now would provide parties greater certainty going forward, make clear what commodities will qualify for the forward contract exemption, and avoid an "I know it when I see it" approach. Accordingly, the IECA suggests consideration of the following:

> **A Financial Commodity is a commodity intended to be settled solely with a cash payment or the entering of an offsetting transaction that is not a bookout, the amount of which is determined according to the price of an index, security, currency, quantitative measure, rate, or instrument of indebtedness, without also conveying a future direct or indirect ownership interest in an asset.**

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28 *See* Order No. 890-A at PP 832-838.

29 p. 29839 col. 3.

30 p. 29827-29.

31 p. 29832 col. 1.

A Non-Financial Commodity is any commodity which is not a Financial Commodity.

6. Environmental Commodities.

The CFTC asks:

> Should the forward contract exclusion from the swap definition apply to environmental commodities such as emissions allowances, carbon offsets/credits, or renewable energy certificates? If so, please describe these commodities, and explain how transactions can be physically settled where the commodity lacks a physical existence (or lacks a physical existence other than on paper)? Would application of the forward contract exclusion to such environmental commodities permit transactions that should be subject to the swap regulatory regime to fall outside the Dodd-Frank Act?[32]

CFTC Regulation 1.3(II) "defines the term 'physical' as 'any good, article, service, right or interest upon which a commodity option may be traded in accordance with the Act and these regulations.'"[33] As options on environmental commodities may be traded in accordance with the Commodity Exchange Act, environmental commodities clearly fit within this definition of "physical" and their exchange would therefore be "physically settled" under current CFTC definitions.

More directly responsive to the CFTC's question, however, is the Report on the Oversight of Existing and Prospective Carbon Markets ("Study")[34] of the Interagency Working Group for the Study on Oversight of Carbon Markets. This Group was tasked under Section 750 of Dodd-Frank with conducting a "study on the oversight of existing and prospective carbon markets to ensure an efficient, secure, and transparent carbon market, including oversight of spot markets and derivative markets," and included designees of two Cabinet Secretaries, the Chairmen of the CFTC, SEC, and FERC, the Administrator of the EPA, and the Commissioner of the Federal Trade Commission. The Study concluded that Carbon allowances were not within the purview of authority granted to the CFTC under Dodd-Frank. The Study calls for oversight of carbon markets, but stated "absent specific action by Congress, neither the CFTC nor any other federal agency may have any authority to routinely monitor trading in the secondary markets or to create rules or regulations that would apply to these markets."[35] "With respect to the carbon derivatives market, to a large extent, once the provisions of the Dodd-Frank Act become effective in July 2011, comprehensive oversight of carbon <u>derivative</u> products, whether traded on an exchange or OTC, will be achieved. However, primary and secondary carbon allowance and offset <u>markets</u> will not be subject to the same comprehensive oversight as derivative markets."[36] By concluding Dodd-Frank was inapplicable to them, the Study necessarily concluded that carbon allowances are not swaps.

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[32] p. 29867 col. 3.
[33] Adaptation NOPR, FR 33068 col. 3.
[34] Available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy_carbon_011811.pdf.
[35] Study, p. 43.
[36] Study, p. 53 (emphasis supplied).

Environmental commodities are very different from the "non-physical commodities" such as interest rates or temperatures that the CFTC references in its adaptation NOPR.[37] These latter are macroeconomic and atmospheric indicators. One can move and physically transfer a Western Renewable Generation Information System (WREGIS) Certificate from account to account, but it is not possible to move and physically transfer a temperature reading. Environmental commodities are things, even if they are intangible. The Study agrees: "unless policymakers choose to differentiate them, allowances are a perfectly homogenous good."[38]

If environmental commodities are not "swaps" within the meaning of the words of the statute, they are not subject to the swap regulatory regime, and are outside the Dodd-Frank Act pursuant to the terms of the Dodd-Frank Act itself; they have not "escaped" or "been permitted" to fall outside Dodd-Frank. Were the CFTC to expand its jurisdiction to cover environmental commodities by defining the commodity itself as a swap, the CFTC would pre-empt the regulatory schemes set by EPA and state environmental and energy regulators for the benefit of the environment and ratepayers. Dodd-Frank was not written to make it more difficult for the regulators with primary jurisdiction over programs establishing allowances, such as the EPA and state regulators, to protect the environment and to otherwise implement and carry out the purposes of their programs.

7. Energy Contracts

The CFTC asks:

> How would the proposed interpretive guidance set forth in this section affect full requirements contracts, capacity contracts, reserve sharing agreements, tolling agreements, energy management agreements, and ancillary services? Do these agreements, contracts, or transactions have optionality as to delivery? If so, should they—or any other agreement, contract, or transaction in a nonfinancial commodity that has optionality as to delivery—be excluded from the swap definition? If so, please provide a detailed analysis of such agreements, contracts, or transactions and how they can be distinguished from options that are to be regulated as swaps pursuant to the Dodd-Frank Act. To what extent are any such agreements, contracts, or transactions in the electric industry regulated by the Federal Energy Regulatory Commission (''FERC''), State regulatory authorities, regional transmission organizations (''RTOs''), independent system operators (''ISOs'') or market monitoring units associated with RTOs or ISOs?[39]

As noted above, the rules proposed by the CFTC could subject all full requirements contracts to the jurisdiction of the CFTC as swaps. The CFTC should rather specifically exclude such contracts. If a transaction is not exchanging a right to receive cash for a right to receive cash, it is not a swap. The energy sector of the economy requires the flexibility to operate with contract certainty without knowing the full quantity that will be required. Temperatures fluctuate, which changes air conditioning or heating demand for power and fuels. The economy fluctuates, which changes manufacturing demand for power and fuels. Variable energy resources, such as wind farms, need to be able to know that their off-takers will purchase all of

[37] Adaptation NOPR, FR 33069 col. 2.
[38] Study, p. 31.
[39] p. 29832 col. 2.

the energy produced, even if the wind changes from hour to hour and day to day, thereby varying the physical output of their wind-driven generators. Much fuel would be wasted if a power company had to take the same quantity every day from a merchant power plant, rather than the quantity it needed that day. Under the CFTC's NOPR, all of these would be swap transactions due to the optionality embedded in their respective delivery obligations.

However, the right to receive all energy one requires on demand, which is the heart of an electric service contract, or the right to sell all energy one produces when one has produced it, which is the heart of a power purchase agreement from the point of view of the generator, is a physically settled right, and not a financial transaction. The transactions that follow the exercise of these rights are not settlements of cash flows based on indices, but rather the receipt of what is needed or the delivery of what is generated. Full requirements contracts, power purchase agreements (especially for variable resources such as wind farms), and tolling agreements necessarily have substantial optionality in terms of quantity delivered. People only take what is needed; rather than agree on a fixed quantity that may lead to waste or the need to resell what is not needed. All electric, gas, and water utility service is based on the concept of meeting full requirements. If all full requirements contracts are "swaps," all utility service, and all generating plant output contracts, will be subject to the jurisdiction not only of the applicable state regulatory and public service commissions, but of the CFTC as well.

8. <u>Federal Special Entity</u>

CEA §1a47(B) says "[t]he term 'swap' does not include: (ix) any agreement, contract, or transaction a counterparty of which is a Federal Reserve bank, the Federal Government, or a Federal agency that is expressly backed by the full faith and credit of the United States… ." Dodd-Frank defines a new concept of "Special Entity" in CEA §4s(h)(2)(C), which includes: "(i) a Federal agency … ." The IECA respectfully requests clarification of what sort of transactions with federal agencies can be "swaps."

<u>Conclusion</u>.

The IECA appreciates the opportunity to provide the foregoing comments and information to the CFTC. The IECA is pleased to make available to the Commission experienced credit and derivatives professionals for further discussion and information upon request.

This letter represents a submission of the IECA, and does not necessarily represent the opinion of any particular member thereof.

Yours truly,
INTERNATIONAL ENERGY CREDIT ASSOCIATION

/s/	/s/
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