CFTC Rule Provides Dodd-Frank Exclusions For Energy Companies

July 17, 2012

On July 10, 2012, the Commodity Futures Trading Commission (“CFTC”) issued its long-awaited rule to further define the term “swap” for purposes of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). In general, the CFTC’s new rule will exclude from Dodd-Frank all transactions that are intended to be physically settled. Depending on the specific facts and circumstances, the new rule will exclude, for example, peaking-supply contracts, full-requirements contracts, tolling agreements, contracts with embedded optionality regarding delivery location or delivery date and contracts for environmental products such as renewable energy credits and emission allowances. Application of the new rules will be extremely fact-specific. Gas and electric utilities and their suppliers should carefully analyze their existing portfolios and ongoing procurement and trading strategies to determine the scope of their Dodd-Frank reporting and other compliance obligations. A summary of the new rule, as it applies to energy companies, is provided below.

Forward Contract Exclusion. A forward contract that imposes a binding future physical delivery obligation for a nonfinancial commodity is not a “swap” if the contract is intended to be physically settled. Examples of nonfinancial commodities include natural gas, fuel oil and electricity. An intangible commodity that can be physically delivered qualifies as a nonfinancial commodity if ownership can be conveyed and the commodity can be consumed. An example of an intangible nonfinancial commodity is an environmental commodity, such as an emission allowance that can be physically delivered and consumed (e.g., by emitting the amount of pollutant specified in the allowance).

Nonfinancial commodities can be physically delivered by, among other things, the seller’s passage of title and the buyer’s payment and acceptance of the underlying commodity; the buyer’s taking delivery of the commodity or passing title to another intermediate purchaser; or physically exchanging (i.e., delivering) one quality, grade or type of physical commodity for another quality, grade or type of physical commodity. A failure to deliver as a result of the exercise by a party of a “bona fide termination right” does not render the transaction ineligible for the forward contract exclusion if the bona fide termination right is triggered by something not expected by the parties at the time the contract was executed. Similarly, the presence of a liquidated damages provision does not render a transaction ineligible for the forward contract exclusion so long as the provision is not masking a lack of intent to deliver.

Forward Contract Book-Outs. A forward contract book-out, offset, cancellation or settlement on a payment-of-differences basis is excluded from the definition of “swap” if: (i) the original contract created a binding obligation to make or take physical delivery without providing any right to offset, cancel or settle on a payment-of-differences basis; (ii) the original contract was between commercial parties that regularly make or take delivery of the referenced...
commodity in their ordinary course of business; (iii) the book-out, offset, cancellation or settlement on a payment-of-differences basis is effectuated through a subsequent, separately negotiated agreement; and (iv) in the event of an oral agreement, such agreement is followed in a commercially reasonable timeframe by a confirmation in written or electronic form. Applying these criteria, the CFTC will consider the specific facts and circumstances of each transaction, including: contract size, demonstrable commercial need for the product, the underlying purpose of the contract (e.g., whether the purpose of the claimed forward was to sell physical commodities, hedge risk or speculate), the regular practices of the commercial entity and whether the absence of physical settlement is based on a change in commercial circumstances.

Physical netting agreements (such as, for example, the Edison Electric Institute Master Power Purchase and Sale Agreement) that net the future delivery amount under one forward contract with an unintentionally offsetting delivery obligation under another forward contract are excluded from the definition of “swap” if they otherwise meet the requirements for a “book-out.”

Commodity Options Embedded in Forward Contracts. A forward contract that contains an embedded commodity option is excluded from the definition of “swap” if the embedded option: (i) may be used to adjust the forward contract price, but does not undermine the overall nature of the contract as a forward contract; (ii) does not target the delivery term, so that the predominant feature of the contract is actual delivery; and (iii) cannot be severed and marketed separately from the overall forward contract in which it is embedded.

An agreement falls within the forward contract exclusion, notwithstanding that it contains embedded volumetric optionality on delivery, when: (i) the embedded optionality does not undermine the overall nature of the agreement as a forward contract; (ii) the predominant feature of the agreement is actual delivery; (iii) the embedded optionality cannot be severed and marketed separately from the overall agreement in which it is embedded; (iv) the seller intends, at the time it enters into the agreement, to deliver the underlying nonfinancial commodity if the optionality is exercised; (v) the buyer intends, at the time it enters into the agreement, to take delivery of the underlying nonfinancial commodity if it exercises the embedded volumetric optionality; (vi) both parties are commercial parties that regularly make or take delivery of the referenced commodity in their ordinary course of business; and (vii) the exercise or nonexercise of the embedded volumetric optionality is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity. Examples of products that could qualify for exclusion from the definition of “swap,” depending on the specific facts and circumstances, include capacity products purchased by load-serving entities in the electric utility industry, transmission (or transportation) service agreements, tolling agreements, peaking supply contracts, full requirements contracts, contracts with evergreen or extension terms and contracts with embedded optionality regarding delivery location or delivery date. Although its interpretation may be relied upon by market participants, the CFTC has requested public comment on all aspects of its interpretation regarding forwards with embedded options.

Physical Commercial Agreements for the Supply and Consumption of Energy. The CFTC specifically addressed 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 CFTC will

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7 Swap Rule at p 87.
8 Swap Rule at 83-84.
9 Swap Rule at p 112.
10 Swap Rule at pp 114-15.
11 Swap Rule at p 115 n.340.
12 Swap Rule at pp 121-22.
13 Swap Rule at pp 121-22.
14 Swap Rule at pp 121-22.
15 Swap Rule at pp 119-20.
16 Swap Rule at p 122.
17 Swap Rule at p 123.
interpret an agreement not to be a “swap” if the following elements are satisfied: (i) the subject of the agreement 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; (ii) the agreement 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 (iii) 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.\(^{18}\) The CFTC would not consider actions such as scheduling electricity transmission, gas transportation or injection of gas into storage to be exercising an option if all three elements of the interpretation above are satisfied.\(^{19}\) “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.”\(^{20}\)

**Energy Asset Management Agreements.** Because commenters did not provide a working definition of the term “Energy Management Agreements” (“EMAs”), the CFTC could not state categorically that such agreements are or are not “swaps.” However, “if the fuel acquisition, sales of excess generation and any other transactions executed under the auspices of an EMA are not swaps, nothing about the fact that the transactions are executed as a result of or pursuant to an EMA transforms the transactions into swaps.”\(^{21}\)

**Trade Options.** In a separate proceeding,\(^{22}\) the CFTC recently adopted a “trade option exemption.” Under this exemption, a commodity option is exempt from some (but not all) Dodd-Frank requirements if: (i) both parties intend that the option, if exercised, will be physically settled; (ii) the option seller is an eligible contract participant or a producer, processor, or commercial user of, or a merchant handling the commodity which is the subject of the commodity option transaction, or the products or by-products thereof, and is offering or entering into the transaction solely for purposes related to its business as such; (iii) the option buyer is a producer, processor or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or by-products thereof, and is entering into the transaction solely for purposes related to its business as such; and (iv) the parties comply with certain recordkeeping and reporting requirements. The CFTC has requested public comments on this rule.

**Regional Transmission Organizations and Independent System Operators.** The CFTC declined to address in its final rule the status of transactions in Regional Transmission Organizations and Independent System Operators, including financial transmission rights and ancillary services. Instead, such exemptions will be considered under the standards and procedures specified in section 722 of the Dodd-Frank Act for a public interest waiver.

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\(^{18}\) Swap Rule at p 130.  
\(^{19}\) Swap Rule at p 130.  
\(^{20}\) Swap Rule at p 130.  
\(^{21}\) Swap Rule at p 134.  