

# CLIENT UPDATE

## CFTC ISSUES FURTHER GUIDANCE ON CERTAIN COMMERCIAL AGREEMENTS ON ENERGY COMMODITIES

### NEW YORK

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On November 14, 2012, the Office of General Counsel (the “OCG”) of the Commodity Futures Trading Commission (the “CFTC”) published a response to frequently asked questions submitted by commenters regarding certain physical commercial agreements for the supply and consumption of energy (the “FAQ”).

### BACKGROUND

The FAQ pertains to a CFTC interpretation (the “Interpretation”) set forth in the adopting release accompanying the final rules<sup>1</sup> published by the CFTC and the Securities and Exchange Commission further defining the terms “swap” and “security-based swap.” The Interpretation provides that an agreement, contract or transaction is not a commodity option if the following conditions are met:

- the subject thereof is usage of a specified facility (or part thereof) rather than purchase or sale of the commodity to be created, transported, processed or stored;
- it grants the buyer exclusive use of the facility (or part thereof) during its term, and unconditionally obligates the seller to grant the buyer exclusive use of the facility (or part thereof); and

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<sup>1</sup> Further definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement; Mixed Swaps; Security-Based Swap Agreement Recordkeeping”. 77 FR 48208 (August 13, 2012).

- payment for the use of the facility (or part thereof) represents payment for its use, rather than the option to use it.<sup>2</sup>

However, the Interpretation provides separately (in the “however paragraph”) that if the right to use the facility is only obtained via payment of a demand charge or reservation fee, and if exercising the right (or using the facility) entails further payment of storage fees, usage fees, rents or other such service charges not included in the demand charge or reservation fee, the agreement, contract or transaction is a commodity option subject to the swap definition.

## COMMENTS

Commenters expressed concern that the “however paragraph” could have the unintended consequence of causing certain physical commercial agreements to be considered commodity options and therefore not eligible for the physical-delivery forward exclusion for nonfinancial commodities from the swap definition since it suggests that every facility usage contract entailing separate payments for both fixed costs (*e.g.*, a demand charge or reservation fee) and variable costs (*e.g.*, storage and usage fees and rents) is a commodity option.

Commenters asserted that such a two-part fee structure for physical service (*i.e.*, the bifurcation of the fee into fixed components (tracking fixed costs) and variable components (tracking use-related costs)) is standard for a wide variety of usage contracts, including storage, interstate transportation, marine vessel chartering, terminal arrangements, tolling agreements for electricity generation and natural gas agreements.<sup>3</sup> Commenters also explained that the demand charge and reservation fee are payments in advance for a physical service rather than payments for the right to later obtain a physical service since the right to use the service for the term of the agreement is legally established upon execution and does not require the further exercise of an option by the buyer.

Finally, commenters inquired whether usage of a specified facility for the creation, transportation, processing or storage of a commodity could be considered a “nonfinancial commodity” and therefore eligible for the trade option exemption in Section 32.3 of the CFTC Regulations.

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<sup>2</sup> The Interpretation also provides that, in evaluating whether flexible physical commercial agreements that meet the three-part test qualify for the forward exclusions, the CFTC will look to the specific facts and circumstances of the agreement, contract or transaction as a whole to evaluate whether it qualifies for the forward exclusion from the swap definition.

<sup>3</sup> Commenters also asserted that a return on investment is often included in the demand charge or reservation fee.

## OCC RESPONSE

In the FAQ, the OCC clarifies that 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 fixed costs upfront and variable costs associated with the commodity later, once those costs are established or incurred. Therefore, the FAQ provides<sup>4</sup> that a facility use agreement, contract or transaction is not a commodity option and is not intended to be covered by the “however paragraph” if:

- the agreement includes a two-part fee structure;
- the right to use the specified portion of the facility for the term of the agreement is legally established upon entering into such agreement;
- the party who has legally established the right to use the specified portion of the facility for the term of the agreement pays the demand charge or reservation fee in a commercially reasonable timeframe (which, absent evasion, would be the appropriate usage of trade or the parties’ normal course of dealing);
- the use of the facility does not depend on the further exercise of an option; and
- 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.

The OCC also clarifies that a facility usage agreement, contract or transaction with a two-part fee structure that fails to meet any of the above conditions may or may not be a commodity option, depending on the specific facts and circumstances taken as a whole. As an example, the OCC notes that, where an agreement, contract or transaction to provide physical commodity creation, transportation, processing or storage service with respect to an underlying agricultural or exempt commodity includes payment of a premium entitling (but not obligating) the buyer to buy or sell such physical commodity, it is likely a commodity option.<sup>5</sup>

Moreover, the OCC confirms in the FAQ that 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 involving such usage that does not satisfy the three

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<sup>4</sup> The OCC notes that nothing in the FAQ applies to “security-based swaps” or “mixed swaps.”

<sup>5</sup> The OCC notes that, since this is just an example of an option on a service, rather than the outer bounds of the CFTC’s authority over options, market participants “should be cognizant,” when developing new products, of sections 1a(47)(A)(iv) and 1a(47)(A)(vi) of the Commodity Exchange Act which, respectively, define as a swap: (1) any agreement, contract or transaction that is, or in the future becomes, commonly known to the trade as a swap and (2) 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.

elements of the Interpretation could still be eligible for the trade option exemption set forth in Section 32.3 of the CFTC Regulations.<sup>6</sup>

Finally, the OCG notes that even if an agreement, contract or transaction is not a commodity option, but is within the physical-delivery forward safe harbor, it is not wholly excluded from the Commodity Exchange Act or the CFTC Regulations for all purposes since the CFTC retains certain residual anti-fraud, anti-manipulation and other authority over forwards.

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Please do not hesitate to contact us if you have any questions.

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<sup>6</sup> In support of this position, the OCG notes that (1) usage of a facility is an exempt commodity (since it is neither an excluded nor an agricultural commodity), (2) nonfinancial commodities are exempt or agricultural commodities that can be physically delivered, and (3) when a buyer of transportation, processing, storage or creation services creates, transports, processes or stores an agricultural or exempt commodity, that service may thereby be physically delivered to the buyer for purposes of Section 32.3(a)(3) of the CFTC Regulations.