DODD-FRANK AND THE ENERGY INDUSTRY: CAN YOU TELL ME IF THIS IS A SWAP?

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I. INTRODUCTION

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[2] was signed into law on July 21, 2010 as a set of major amendments to the Commodity Exchange Act ("CEA").[3] Over the following years, the Commodity Futures Trading Commission ("CFTC"), together with the Securities and Exchange Commission ("SEC") and a group of less well-known agencies, have labored over rules and regulations to implement the law. Unfortunately, while the agencies have now spoken initially to many areas of implementation related to the energy industry, issues of critical importance to public power entities engaged in power transactions remain unresolved or unclear.

The Dodd-Frank Act was designed first and foremost to address systemic risks that contributed to the global financial collapse of 2008. At more than 2800 pages long, the law was expansive and ambitious, and created entirely new agencies and requirements for previously unregulated sectors of the economy.

Congress was particularly concerned to regulate transactions called "derivatives," so called because they derive their underlying value from the value of the commodity on which they are based. When derivative contracts were transacted "over-the-counter" ("OTC") rather than through regulated central exchanges, risks related to lack of transparency, insufficient collateralization and loose controls destabilized the financial markets. At the time of the financial collapse, American International Group, or AIG, had $79 billion in derivatives exposure to mortgage-related securities.[4] The Financial Crisis Inquiry Commission, a panel convened to examine the causes of the financial collapse, stated, "We conclude over-the-counter derivatives contributed significantly to this crisis."[5]

While transactions in the energy markets played little to no role in the collapse of the financial markets, the example of Enron and the energy market upheavals created by its unregulated transactions was fresh in the memories of legislators and that history assured that the Dodd-Frank Act would eliminate many of the exemptions that energy transactions had

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[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act").

[3] Commodity Exchange Act of 1936, ch. 545, 49 Stat. 1491 (codified at 7 U.S.C. §§ 1-27f) ("CEA").

[4] The Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* xix (2011), *available at* http://fcic.law.stanford.edu/report.

[5] *Id.* at xxiv.

previously enjoyed from CFTC regulation.[6] Congress eliminated the exemptions, however, without resolving the confusion created by the interaction of the CEA and the Federal Power Act ("FPA") which give each agency exclusive jurisdiction over certain aspects of energy transactions in a way that set the stage for agency jurisdictional disputes and confusion for entities who could be regulated by both agencies.

A key challenge for the CFTC in implementing the Dodd-Frank Act was its starting point as an administrative agency that—due to the historical exemptions—historically lacked knowledge of the energy industry, including the ins and outs of its markets, as well as the nature and diversity of participants in those markets. Prior to passage of the Dodd-Frank Act, the CFTC maintained authority to monitor energy markets for manipulative and fraudulent trading,[7] but only recently had begun to exert this authority, and lacked entirely the broad authority that the Commodity Exchange Act, as amended by the Dodd-Frank Act, now grants the agency to regulate energy industry transactions.

On August 13, 2012, the CFTC, in conjunction with the SEC, issued the long-awaited rule further defining "swap" and related terms.[8] In this key rule, the CFTC attempted to address the comments and concerns of various energy industry groups, including those of the Not-for-Profit Electric End User Coalition ("NFP EEU"),[9] which had submitted comments and requested clarification on central questions such as the treatment of non-financial commodities, book-outs, and options. The final rule evidenced the CFTC's efforts to understand and, to some degree, accommodate the input it received from regulated groups including the NFP EEU, but it also addressed only concerns specifically raised in comments during the proceeding, leaving tremendous uncertainty for market participants attempting to make day to day business in their potentially regulated power transactions.

In addition to the definition of swaps, several CFTC-issued exemptions are key for public power decision-makers seeking to analyze and identify the likely regulatory status of their transactions. The two most significant exemptions are the CFTC's final rule establishing what is known as the "201(f) exemption" from swaps regulation,[10] and its final order exempting from regulation certain specified transactions in RTO markets.[11] Both of these exemptions were issued on April 2, 2013, on the eve of implementation of the CFTC's rules. The end-user

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[6] For background on the historical lack of regulation of energy under the Commodity Exchange Act, see Mark Jickling, *Regulation of Energy Derivatives, CRS Report for Congress* (Apr. 21, 2006), *available at* http://digital.library.unt.edu/ark:/67531/metacrs10584/m1/1/high_res_d/RS21401_2008May12.pdf.

[7] CEA § 9(a)(2), 7 U.S.C. § 13(a)(2).

[8] Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,208 (Aug. 13, 2012), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-18003a.pdf. A "swap" is a derivative.

[9] APPA and the Transmission Access Policy Study Group ("TAPS") are among the members of the NFP EEU coalition.

[10] Order Exempting, Pursuant to Authority of the Commodity Exchange Act, Certain Transactions Between Entities Described in the Federal Power Act, and Other Electric Cooperatives, 78 Fed. Reg. 19,670 (Apr. 2, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-07633a.pdf.

[11] Final Order in Response to a Petition From Certain Independent System Operators and Regional Transmission Organizations to Exempt Specified Transactions Authorized by a Tariff or Protocal Approved by the Federal Energy Regulatory Commission or the Public Utility Commission of Texas From Certain Provisions of the Commodity Exchange Act Pursuant to the Authority Provided in the Act, 78 Fed. Reg. 19,880 (Apr. 2, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-07634a.pdf.

exception to the clearing requirement otherwise applicable to swaps is a third important exemption.[12] This paper will primarily focus on these rules and their impact on public power entities.

II. DISCUSSION

A pressing question for many public power entities is: which transactions will be subject to scrutiny by the CFTC, in the Dodd Frank world? This question is central to assessing risk, determining what transactions are appropriate to enter into with which partners, and drafting contracts that,to the extent possible, will minimize problems or risks that might arise further down the line. Unfortunately it is impossible to answer this question with complete confidence given there has not been sufficient time since the passage of the CFTC's rules to allow the agency to apply its rules and create guiding precedent, and the CFTC itself is not inclined to provide clear roadmaps of "safe" transactions lest it enable potential violators to design products that would meet the letter of the law while evading the spirit. However, the three exemptions described above help to define certain boundaries of the CFTC's current range of concerns and provide clues as to which transactions are most likely to be scrutinized.

A) The 201(f) Exemption

While the obvious place to start a discussion of what transactions are subject to scrutiny would be with the CFTC's definition of "swap," for public power entities, an even more basic question than whether a transaction is a swap, is whether a transaction is eligible for the 201(f) exemption from swaps regulation. If eligibility for this exemption can be established as a threshold matter, then further analysis may be unnecessary.

Section 4(a) of the Commodity Exchange Act, as amended by the Dodd-Frank Act, prohibits over-the-counter trading in commodities, forcing swaps into central clearinghouses[13] in

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[12] CEA § 2(h)(7)(A), 7 U.S.C. § 2(h)(7)(A).
[13] CEA § 4(a), 7 U.S.C. § 6(a) reads as follows:

> (a) Restriction on futures trading
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> Unless exempted by the Commission pursuant to subsection (c) or by subsection (e), it shall be unlawful for any person to offer to enter into, to enter into, to execute, to confirm the execution of, or to conduct any office or business anywhere in the United States, its territories or possessions, for the purpose of soliciting or accepting any order for, or otherwise dealing in, any transaction in, or in connection with, a contract for the purchase or sale of a commodity for future delivery (other than a contract which is made on or subject to the rules of a board of trade, exchange, or market located outside the United States, its territories or possessions) unless—
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> (1) such transaction is conducted on or subject to the rules of a board of trade which has been designated or registered by the Commission as a contract market or derivatives transaction execution facility for such commodity;
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> (2) such contract is executed or consummated by or through a contract market; and

an effort to make the markets more transparent to regulators and the public, and in order to enable the imposition of checks and balances. However, Section 4(c) of the CEA grants the CFTC the authority to issue exemptions from the mandates of Section 4(a).

Section 4(c) of the Commodity Exchange Act provides a number of potential bases for exemptions from swaps regulation. The CFTC may issue an exemption *sua sponte* or in response to an application for exemption:[14]

> (c) Public interest exemptions.
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> (1) In order to promote responsible economic or financial innovation and fair competition, the Commission by rule, regulation, or order, after notice and opportunity for hearing, may (on its own initiative or on application of any person, including any board of trade designated or registered as a contract market or derivatives transaction execution facility for transactions for future delivery in any commodity under section 7 of this title) exempt any agreement, contract, or transaction (or class thereof) that is otherwise subject to subsection (a) of this section (including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to, the agreement, contract, or transaction), either unconditionally or on stated terms or conditions or for stated periods and either retroactively or prospectively, or both, from any of the requirements of subsection (a) of this section, or from any other provision of this chapter….

CEA Section 4(c)(1)(B) provides the mechanism by which such an exemption is made (citations omitted):[15]

> (B) the Commission and the Securities and Exchange Commission may by rule, regulation, or order jointly exclude any agreement, contract, or transaction from section 2(a)(1)(D) of this title if the Commissions determine that the exemption would be consistent with the public interest.

Section 4(c)(6) specifically authorizes the CFTC to grant exemption to agreements entered into "pursuant to a tariff or rate schedule approved or permitted to take effect by the

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> (3) such contract is evidenced by a record in writing which shows the date, the parties to such contract and their addresses, the property covered and its price, and the terms of delivery: Provided, That each contract market or derivatives transaction execution facility member shall keep such record for a period of three years from the date thereof, or for a longer period if the Commission shall so direct, which record shall at all times be open to the inspection of any representative of the Commission or the Department of Justice.

[14] CEA § 4(c), 7 U.S.C. § 6(c).
[15] CEA § 4(c)(1)(B), 7 U.S.C. § 6(c)(1)(B).

Federal Energy Regulatory Commission" or between entities described in "section 824(f) of Title 16" of the U.S. Code – i.e., Federal Power Act Section 201(f):[16]

> (6) If the Commission determines that the exemption would be consistent with the public interest and the purposes of this chapter, the Commission shall, in accordance with paragraphs (1) and (2), exempt from the requirements of this chapter an agreement, contract, or transaction that is entered into—
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> (A) pursuant to a tariff or rate schedule approved or permitted to take effect by the Federal Energy Regulatory Commission;
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> (B) pursuant to a tariff or rate schedule establishing rates or charges for, or protocols governing, the sale of electric energy approved or permitted to take effect by the regulatory authority of the State or municipality having jurisdiction to regulate rates and charges for the sale of electric energy within the State or municipality; or
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> (C) **between entities described in section 824(f) of Title 16.**

On June 8, 2012, the Not-for-Profit Electric End User Coalition, a trade group including APPA, TAPS, and The National Rural Electric Cooperative Association ("NRECA"), among others, submitted an application for exemption under CEA Section 4(c) to the CFTC. After a certain amount of back-and-forth and information gathering, the CFTC issued an eleventh-hour final rule on April 2, 2013 (the eve of the otherwise-applicable swaps reporting deadline), largely satisfying the NFP EEU's request for exemption, exempting from swaps regulation certain transactions between and among 201(f) entities (federal, state and municipal utilities), as well as cooperatives that are not 201(f) entities, and Indian tribes.

The Commission explains that this exemption is above and beyond the "end-user exception" to the clearing requirement for swaps:[17]

> The Commission is persuaded that Congress intended for the Commission to consider providing relief for transactions managing price risk entered into between FPA section 201(f) entities that goes beyond the relief available through the end-user exemption for price hedging transactions, if in the public interest.

Specifically, the CFTC exempts from swaps regulation—but not from its general authority to monitor for and take action against fraud and market manipulation[18]—a defined category of "Exempt Non-Financial Energy Transactions" between and among "Exempt Entities." Exempt Entities include the federal power marketing administrations ("PMA"), utilities owned by state and municipal governments and joint action agencies, tribal utilities,

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[16] CEA § 4(c)(6), 7 U.S.C. § 6(c)(6) (emphasis added).
[17] Order Exempting Certain Transactions, 78 Fed. Reg. at 19,677.
[18] *Id.* at 19,688 ("The relief provided herein is subject to the Commission's general anti-fraud and anti-manipulation authority, and scienter-based prohibitions…and any implementing regulations.").

cooperative utilities and "any other entity that is wholly owned, directly or indirectly, by any one or more of the foregoing:"[19]

> (i) any electric facility or utility that is wholly owned by a government entity, as described in Federal Power Act (''FPA'') section 201(f), 16 U.S.C. 824(f); (ii) any electric facility or utility that is wholly owned by an Indian tribe recognized by the U.S. government pursuant to section 104 of the Act of November 2, 1994, 25 U.S.C. 479a–1; (iii) any electric facility or utility that is wholly owned by a cooperative, regardless of such cooperative's status pursuant to FPA section 201(f), so long as the cooperative is treated as such under Internal Revenue Code section 501(c)(12) or 1381(a)(2)(C), 26 U.S.C. 501(c)(12), 1381(a)(2)(C), and exists for the primary purpose of providing electric energy service to its member/owner customers at cost; or (iv) any other entity that is wholly owned, directly or indirectly, by any one or more of the foregoing. The term ''Exempt Entity'' does not include any ''financial entity,'' as defined in CEA section 2(h)(7)(C).

Exempt Non-Financial Energy Transactions include six types of transactions: (1) electric energy delivered, (2) generation capacity, (3) transmission services, (4) fuel delivered, (5) cross-commodity pricing, and (6) other goods and services.[20] These categories of transaction appear to cover most of the relevant transactions that are carried out on a daily basis by public power entities, such as full requirements contracts, transmission services agreements, tolling agreements, heat rate transactions, and facilities services agreements. The categories are defined more specifically (although not in great detail) as follows:[21]

> 1. *Electric Energy Delivered* transactions consist of arrangements in which a provider Exempt Entity agrees to deliver electric energy to a recipient Exempt Entity within a geographic service territory, load, or electric system over a period of time. Such transactions include ''full requirements'' contracts, under which one Exempt Entity becomes obligated to provide, and the recipient Exempt Entity becomes obligated to take, all of the electric energy the recipient needs to provide reliable electric service to its fluctuating electric load over a specified delivery period at one or multiple delivery points or locations, net of any electric energy the recipient is able to produce through generation assets that it owns.
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> 2. *Generation Capacity* transactions consist of agreements in which a recipient Exempt Entity purchases from a provider Exempt Entity the right to call upon the provider Exempt Entity's

[19] *Id.* The definition of Exempt Entities excludes financial entities, but the CFTC has stated that "most state and local government entities are not likely to be 'financial entities' under Section 2(h)(7)(C)(VIII)." End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560, 42,563 (July 19, 2012).

[20] Order Exempting Certain Transactions, 78 Fed. Reg. at 19,688.

[21] *Id*.

electric energy generation assets to supply electric energy within a geographic area, regardless of whether such right is ever exercised for the purposes of the recipient Exempt Entity meeting its location-specific reliability obligations. Such transactions also may specify certain conditions that must exist prior to exercising the right to use an Exempt Entity's generation assets, or establish an agreement between Exempt Entities to share pooled electric generation assets in order to satisfy regionally-imposed demand side management program requirements.

3. *Transmission Services* transactions consist of arrangements in which a provider Exempt Entity owning transmission lines sells to a recipient Exempt Entity the right to deliver the recipient Exempt Entity's electric energy from one designated point on the transmission lines to another, at a price per wattage and over a period of time, in order for the recipient Exempt Entity to provide electric energy to its customers. Such transactions may include ancillary services related to transmission such as congestion management and system losses.

4. *Fuel Delivered* transactions consist of arrangements used to buy, sell, transport, deliver, or store fuel used in the generation of electric energy by an Exempt Entity. Additionally, Fuel Delivered transactions may include an agreement to manage the operational basis or exchange (i.e., location or time of delivery) risk of an Exempt Entity that arises from its location-specific, seasonal or otherwise variable operational need for fuel to be delivered.

5. *Cross-Commodity Pricing* transactions consist of arrangements such as heat rate transactions and tolling agreements in which the price of electric energy delivered is based upon the price of the fuel source used to generate the electric energy. Cross-Commodity transactions also include fuel delivered agreements in which the price paid for fuel used to generate electric energy is based upon the amount of electric energy produced.

6. *Other Goods and Services* transactions consist of arrangements in which the Exempt Entities enter into an agreement to share the costs and economic benefits related to construction, operation, and maintenance of facilities for the purposes of generation, transmission, and delivery of electric energy to customers. In a full requirements contract between Exempt Entities that share ownership of generation assets, the provider Exempt Entity may determine how generation to meet the recipient Exempt Entity's full requirements will be allocated among the provider's independent generation assets, the jointly-owned generation assets, and the recipient's independent generation assets. Other Goods and Services transactions also may include agreements between Exempt Entities to operate each other's facilities, share equipment and employees, and interface on each other's behalf with third

> parties such as suppliers, regulators and reliability authorities, and customers, regardless of whether such agreements are triggered as contingencies in emergency situations only or are applicable during the normal course of operations of an Exempt Entity.

Notably, the exemption does not apply to fuel that is sold by a municipal utility for purposes other than the generation of electric power, such as natural gas that is sold to consumers for residential or commercial use. The CFTC specifically excludes from the definition of Exempt Non-Financial Energy Transactions any transaction that is "based upon, derived from, or referencing any interest rate, credit, equity or currency asset class, or any grade of a metal, or any agricultural product, or any grade of crude oil or gasoline that is not used as fuel for electric energy generation."[22] The main type of fuel sale included among the list of Exempt Non-Financial Energy Transactions is "fuel delivered" transactions. However, these are defined as "arrangements used to buy, sell, transport, deliver, or store fuel used in the generation of electric energy by an Exempt Entity."[23] The reason that the exemption does not extend to the sale of natural gas by a municipal utility is because the language Congress used in the Dodd-Frank Act to amend the CEA referred only to Section 201(f) of the Federal Power Act (which applies only to electric power utilities). The Natural Gas Act lacks a comparable provision for natural gas distribution companies. It is possible that natural gas entities will seek a similar exemption at some later date.

In any event, public power entities that carry out electric energy transactions with other public power entities, including federal PMAs, state or local entities, cooperatives and tribal utilities, should be reasonably assured that those transactions will not be swept up in the CFTC's swaps regulatory regime. Obviously, the fact that PMA purchases and sales, transactions between and among joint action agencies and their members and Generation and Transmission ("G&T") Cooperatives and their members are exempt can greatly assist those entities in managing their regulatory risks. It is certainly an incentive for government, cooperative and tribal utilities to deal with each other in many cases. The universe of transactions exempted is fairly broad, and the CFTC's intent seems to be to capture most of the regular contractual interactions between public entities.[24] However, complications could arise where a transaction that involves two such entities also involves, at some point in the arrangement, entities other than Exempt Entities. If an IOU is involved as an intermediary in the delivery of energy, or as a third party in a facilities ownership agreement, for example, or if a financial institution is entwined in the hedging arrangements of two municipal entities, then special analysis may be necessary as to the applicability of the 201(f) exemption.

The CFTC's 201(f) exemption as initially proposed was problematic because it was essentially limited to physically settled transactions. In other words, it addressed forward contracts that ought not to have been considered swaps in any case.[25] The final exemptive order

[22] *Id.*
[23] *Id*.
[24] The CFTC declined to grant an even broader waiver of applicability, perhaps because it is harder to later amend a categorical waiver than it is to amend an enumerated list. The same concept probably applies to the CFTC's rule exempting certain RTO transactions, as described below.
[25] The CFTC's Proposed Order would have limited Exempt Non-Financial Energy Transactions to "those agreements, contracts, or transactions entered into between Exempt Entities primarily in order 'to

corrected this problem, making clear that 201(f) transactions, even if they are "real" swaps, can continue to be included in a portfolio of options for hedging the risks of your underlying electric utility operations. However, these transactions must be distinguished from purely financial plays, such as interest rate swaps, that are not based on underlying commodities that you may buy and sell to hedge utility risks. These types of swaps are excluded from the exemption. Moreover, if you choose to venture into the arena of true swaps that are executed or cleared on exchanges, the 201(f) exemption does not follow you there, and your utility will be subject to all the requirements related to any entity choosing to participate in those markets.[26]

B) RTO Transactions

Also under Section 4(c)(6) of the Commodity Exchange Act, on February 7, 2012, a petition for exemption was submitted to the CFTC by CAISO, MISO, ISO-NE, PJM, NYISO, and ERCOT.[27] These entities collectively requested that the CFTC exempt from regulation as swaps a swath of contracts, agreements, and transactions for the purchase or sale of specified electricity products that are (or may be) offered in their markets pursuant to a FERC- or PUCT-approved tariff. These included "financial transmission rights," "energy transactions," "forward capacity transactions," and "reserve or regulation transactions."[28]

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satisfy existing or anticipated contractual obligations to facilitate the generation, transmission, and/or delivery of electric energy service to customers at the lowest cost possible, and the agreement, contract, or transaction is intended for making or taking physical delivery of the commodity upon which the agreement, contract, or transaction is based.'" Proposal To Exempt Certain Transactions Involving Not-for-Profit Electric Utilities, 77 Fed. Reg. 50,998, 51,007 (Aug. 23, 2012).

[26] The final rule excludes certain types of transactions from the exemption as follows (Order Exempting Certain Transactions, 78 Fed. Reg. at 19,688):

> B. *Exempt Non-Financial Energy Transaction* means any agreement, contract, or transaction based upon a ''commodity,'' as such term is defined in CEA section 1a(9) and Commission regulation 1.3(e), that would not have been entered into, but for an Exempt Entity's need to manage supply and/or price risks arising from its existing or anticipated public service obligations to physically generate, transmit, and/or deliver electric energy service to customers. The term ''Exempt Non-Financial Energy Transaction'' excludes agreements, contracts, and transactions based upon, derived from, or referencing any interest rate, credit, equity or currency asset class, or any grade of a metal, or any agricultural product, or any grade of crude oil or gasoline that is not used as fuel for electric energy generation. The term ''Exempt Non-Financial Energy Transaction'' also excludes agreements, contracts, or transactions entered into on or subject to the rules of a registered entity, submitted for clearing to a derivatives clearing organization, and/or reported to a swap data repository.

[27] SPP, which lacked "Day 2" markets at the time of the joint petition, did not join the request, and will not be covered by the exemption unless similar showings are made. We understand that SPP submitted a separate petition for exemption to the CFTC on October 1, 2013. However, at the time of drafting this paper, that petition was not available on the CFTC's website, presumably due to the closure of the federal government.

[28] Proposed Order and Request for Comment on a Petition From Certain Independent System Operators and Regional Transmission Organizations To Exempt Specified Transactions Authorized by a Tariff on Protocol Approved by the Federal Energy Commission or the Public Utility Commission of Texas From Certain Provisions of the Commodity Exchange Act, 77 Fed. Reg. 52,138, 52,141 (Aug. 28, 2012).

In response, the CFTC launched a rulemaking considering the requested exemptions. In its NOPR, the CFTC pointed to its own "exclusive jurisdiction" over "swaps as well as futures."[29] The NOPR quoted the following language from CEA Section 2(a)(1)(A):[30]

> The Commission shall have exclusive jurisdiction, except to the extent otherwise provided in the Wall Street Transparency and Accountability Act of 2010 . . . with respect to . . . agreements (including any transaction which is of the character of …an "option"), and transactions involving swaps or contracts of sale of a commodity for future delivery (including significant price discovery contracts) traded or executed on a contract market . . . or a swap execution facility. . . or any other board of trade, exchange, or market . . . ."

The NOPR acknowledged that "[t]he Dodd-Frank Act also added a savings clause that addresses the roles of the Commission, FERC, and state agencies as they relate to certain agreements, contracts, or transactions traded pursuant to the tariff of an RTO and ISO."[31] The NOPR further pointed out that[32]

> CEA section 2(a)(1) repeats the [CFTC's] exclusive jurisdiction and clarifies that the [CFTC] retains its authorities over agreements, contracts or transactions traded pursuant to FERC- or state-approved tariff or rate schedules . . .

but that [33]

> [t]he same paragraph (I) also explains that the FERC and state agencies preserve their existing authorities over agreements, contracts, or transactions "entered into pursuant to a tariff or rate schedule approved by [FERC] or a State regulatory agency," that are: "(I) not "executed, traded, or cleared on" an entity or trading facility subject to registration or "(II) executed, traded, or cleared on a registered entity or trading facility owned or operated by a [RTO] or [ISO]."

In short, the jurisdictional issues between the CFTC and FERC are messy and deeply involved with the CFTC's treatment of transactions carried out in RTOs. The CFTC's final order, while conditionally granting exemption from swaps regulation to certain categories of transactions carried out in RTOs, evidences the CFTC's attempt to hold onto its authority to impose constraints on RTOs, despite the fact that RTOs are a beast of FERC's anointment, if not creation.

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[29] *Id*. at 52,139.
[30] *Id.* (*citing* 7 U.S.C. § 2(a)(1)(A)).
[31] *Id.* (*citing* 7 U.S.C. § 2(a)(1)(I)).
[32] *Id.* (*citing* 7 U.S.C. § 2(a)(1)(I)(i) and (ii)).
[33] *Id.* at 52,139-40 (*citing* 7 U.S.C. § 2(a)(1)(I)(i)(II)).

The same day that the CFTC issued its final order exempting certain transactions between 201(f) entities, the agency also issued its final order on transactions carried out in RTOs/ISOs. The final order exempts specified transactions from regulation as swaps, subject to certain conditions including that the relevant RTO's satisfy a number of preliminary conditions. RTOs to which the order applies are CAISO, MISO, ISO-NE, PJM, NYISO, and ERCOT.[34]

The relevant RTOs have already satisfied a number of conditions required by the CFTC. This included taking steps to comply with FERC Regulation 35.47, implementing the reform of RTO risk and credit practices.[35] (The CFTC treats ERCOT separately, requiring similar protocols, due to its unique historical status as being not subject to FERC regulation.[36]) The CFTC also required each RTO to provide a legal memorandum from outside counsel giving adequate assurance that any relevant netting arrangements provide the RTO with enforceable rights to set off against market participants should they enter bankruptcy.[37] Covered entities must furthermore comply with certain ongoing information-sharing and notification requirements.[38]

The exemption order applies to the purchase or sale of four products. These products are 1) financial transmission rights, 2) energy transactions, 3) forward capacity transactions, and 4) reserve or regulation transactions that are offered or sold in a market administered by one of the petitioning RTOs pursuant to a tariff or protocol approved or permitted to take effect by FERC or PUCT.[39] The rule provides generic definitions for each of these covered products:[40]

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[34] *Id.* at 52,138.

[35] The final CFTC rule describes required reforms as follows (Final Order in Response to Petition, 78 Fed. Reg. at 19,889):

> These credit reforms include limitations on the amount of credit an RTO or ISO may extend for each market participant; shortened billing and settlement periods of no more than seven days; the elimination of unsecured credit in FTR or equivalent markets; requiring RTOs and ISOs to ensure the enforceability of their netting arrangements in the event of the insolvency of a member by
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> (1) establishing a single counterparty to all market participant transactions,
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> (2) requiring each market participant to grant a security interest in the receivables of its transactions to the relevant RTO or ISO, or
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> (3) providing another method that supports netting that is approved by FERC and that provides a similar level of protection to the market; adoption of a two-day grace period for curing collateral calls; establishment of minimum market participation eligibility requirements that apply consistently to all market participants and that require RTOs and ISOs to engage in periodic verification of market participant risk management policies and procedures; and Tariff clarifications regarding the conditions under which RTOs and ISOs will request additional collateral due to a material adverse change.

[36] *Id*. at 19,889-90.

[37] *Id*. at 19,890-91.

[38] *Id*. at 19,891-92.

[39] *Id.* at 19,882-83.

[40] *Id.* at 19,913-14.

a. A ‘‘Financial Transmission Right’’ is a transaction, however named, that entitles one party to receive, and obligates another party to pay, an amount based solely on the difference between the price for electric energy, established on an electric energy market administered by a Requesting Party, at a specified source (*i.e.,* where electric energy is deemed injected into the grid of a Requesting Party) and a specified sink (*i.e.,* where electric energy is deemed withdrawn from the grid of a Requesting Party). The term ‘‘Financial Transmission Rights’’ includes Financial Transmission Rights and Financial Transmission Rights in the form of options (*i.e.,* where one party has only the obligation to pay, and the other party only the right to receive, an amount as described above).

b. ‘‘Energy Transactions’’ are transactions in a ‘‘Day-Ahead Market’’ or ‘‘Real-Time Market,’’ as those terms are defined in paragraphs 5(e) and 5(f) of this Order, for the purchase or sale of a specified quantity of electric energy at a specified location (including virtual and convergence bids and offers), where:

(1) The price of the electric energy is established at the time the transaction is executed;

(2) Performance occurs in the Real-Time Market by either

(a) Delivery or receipt of the specified electric energy, or

(b) A cash payment or receipt at the price established in the Day-Ahead Market or Real-Time Market (as permitted by each Requesting Party in its Tariff); and

(3) The aggregate cleared volume of both physical and cash-settled energy transactions for any period of time is limited by the physical capability of the electric energy transmission system operated by a Requesting Party for that period of time.

c. ‘‘Forward Capacity Transactions’’ are transactions in which a Requesting Party, for the benefit of load-serving entities, purchases any of the rights described in subparagraphs (1), (2), and (3) below. In each case, to be eligible for the exemption, the aggregate cleared volume of all such transactions for any period of time shall be limited to the physical capability of the electric energy transmission system operated by a Requesting Party for that period of time.

(1) ‘‘Generation Capacity,’’ meaning the right of a Requesting Party to:

(a) Require certain sellers to maintain the interconnection of electric generation facilities to specific physical locations in the electric-energy transmission system during a future period of time as specified in the Requesting Party's Tariff;

(b) Require such sellers to offer specified amounts of electric energy into the Day-Ahead or Real-Time Markets for electric energy transactions; and

(c) Require, subject to the terms and conditions of a Requesting Party's Tariff, such sellers to inject electric energy into the electric energy transmission system operated by the Requesting Party;

(2) ''Demand Response,'' meaning the right of a Requesting Party to require that certain sellers of such rights curtail consumption of electric energy from the electric energy transmission system operated by a Requesting Party during a future period of time as specified in the Requesting Party's Tariff; or

(3) ''Energy Efficiency,'' meaning the right of a Requesting Party to require specific performance of an action or actions that will reduce the need for Generation Capacity or Demand Response Capacity over the duration of a future period of time as specified in the Requesting Party's Tariff.

d. ''Reserve or Regulation Transactions'' are transactions: the benefit of load-serving entities and resources, purchases, through auction, the right, during a period of time as specified in the Requesting Party's Tariff, to require the seller of such right to operate electric facilities in a physical state such that the facilities can increase or decrease the rate of injection or withdrawal of a specified quantity of electric energy into or from the electric energy transmission system operated by the Requesting Party with:

(1) physical performance by the seller's facilities within a response time interval specified in a Requesting Party's Tariff (Reserve Transaction); or (b) prompt physical performance by the seller's facilities (Area Control Error Regulation Transaction);

(2) For which the seller receives, in consideration, one or more of the following:

(a) Payment at the price established in the Requesting Party's Day-Ahead or Real-Time Market, as those terms are defined in paragraphs 5(e) and 5(f) of this Order, price for electric energy applicable whenever the Requesting Party exercises its

> right that electric energy be delivered (including Demand Response,'' as defined in paragraph 5(c)(2) of this Order);
>
> (b) Compensation for the opportunity cost of not supplying or consuming electric energy or other services during any period during which the Requesting Party requires that the seller not supply energy or other services;
>
> (c) An upfront payment determined through the auction administered by the Requesting Party for this service;
>
> (d) An additional amount indexed to the frequency, duration, or other attributes of physical performance as specified in the Requesting Party's Tariff; and
>
> (3) In which the value, quantity, and specifications of such transactions for a Requesting Party for any period of time shall be limited to the physical capability of the electric energy transmission system operated by the Requesting Party for that period of time.

To be eligible for the exemption, the parties to the transaction must qualify. Qualifying transactions must be entered into by persons who are: "[(1)] "appropriate persons," as defined in sections 4(c)(3)(A) through (J) of the [CEA], [(2)] "eligible contract participants," as defined in section 1a(18) of the [CEA] and Commission regulations, or [(3)] persons who are in the business of: (i) Generating, transmitting, or distributing electric energy, or (ii) providing electric energy services that are necessary to support the reliable operation of the transmission system."[41] However, there should be no difficulty for most municipal power entities to satisfy one or more of these standards.

The final order also exempts from the CFTC's swaps regime "persons offering, entering into, rendering advice, or rendering other services with respect to [those transactions]."[42] RTO-related transactions settled bilaterally outside of RTO markets will be discussed in the presentation.

C) Further Definition of Swap

The most helpful thing about the exemptions for contracting parties is that they narrow the scope of transactions that must be examined as potentially subject to CFTC regulation. Once a utility can eliminate transactions in RTO markets and those that take place with other exempt parties, the universe of concern generally can narrow to bilateral contracts with traditional IOU utilities, marketers, generators and others that take place outside of RTO markets. To the extent that a utility can minimize these types of transactions, the risk of attracting CFTC interest can be reduced. However, there is also no doubt that most public power entities have no choice but to engage in power sales and purchase transactions with their local IOUs or with the generators in

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[41] *Id.* at 19,880.
[42] *Id.*

their areas, and that many such transactions must occur outside of RTO markets. For such transactions, there is no choice but to grapple with the definitions the CFTC has provided as to what transactions may or may not be swaps. The remainder of this paper addresses those questions.

The primary question for CFTC purposes is whether we are dealing with a swap or a forward contract. The Dodd-Frank Act subjects energy commodities to the reach of the Commodity Exchange Act, including the requirement that all swaps be cleared through a trading platform such as a commodities exchange. However, the Dodd-Frank Act distinguishes swaps, which are intended to be settled financially, from forward (advance) contracts (contracts providing for the delivery of a commodity at some point in the future), which are intended to be fulfilled through physical delivery. CFTC jurisdiction extends to swaps, but not to pure forward contracts, with the exception of certain position limits and the CFTC's market manipulation enforcement authority. There is also a sub-category of transaction that should not be thought of as separate from a swap, but which the CFTC gives special treatment—a variety of swap known as the "trade option."

The Commodity Exchange Act, as amended by the Dodd-Frank Act, includes a definition of "swap":[43]

> (47) Swap
>
> (A) In general
>
> Except as provided in subparagraph (B), the term "swap" means any agreement, contract, or transaction—
>
> (i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind;
>
> (ii) that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence;
>
> (iii) that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future

[43] CEA § 1a(47)(A), 7 U.S.C. § 1a(47)(A).

change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred, including any agreement, contract, or transaction commonly known as—

(I) an interest rate swap;

(II) a rate floor;

(III) a rate cap;

(IV) a rate collar;

(V) a cross-currency rate swap;

(VI) a basis swap;

(VII) a currency swap;

(VIII) a foreign exchange swap;

(IX) a total return swap;

(X) an equity index swap;

(XI) an equity swap;

(XII) a debt index swap;

(XIII) a debt swap;

(XIV) a credit spread;

(XV) a credit default swap;

(XVI) a credit swap;

(XVII) a weather swap;

(XVIII) an energy swap;

(XIX) a metal swap;

(XX) an agricultural swap;

(XXI) an emissions swap; and

(XXII) a commodity swap;

(iv) that is an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap;

(v) including any security-based swap agreement which meets the definition of "swap agreement" as defined in section 206A of the Gramm-Leach-Bliley Act (15 U.S.C. 78c note) of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein; or

> (vi) that is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v).

Despite the fact that this statutory definition appears somewhat long, it is insufficient to delineate what is and is not a swap. This is particularly true with respect to transactions in the energy industry, given that the definition simply lists "commodity swap" among the enumerated generic transactions, absent any indication of what constitutes a commodity swap. However, the statute does include a critical *exclusion* from the definition of swap, namely "any sale of a nonfinancial commodity . . . for deferred shipment or delivery, so long as the transaction is intended to be physically settled."[44] In other words, it excludes forward contracts where physical delivery is intended.

In recognition that the statutory definition would be insufficient, the Dodd-Frank Act provided that the term "swap" should be further defined at the agency level.[45] Consequently, the CFTC, in combination with the SEC, published a final order on August 13, 2012 outlining a "further" definition of the term.[46] The CFTC's further definition of the term swap confirms that true forward transactions are statutorily exempt from CFTC regulation as swaps.[47] This exemption exists because, according to the CFTC, "[t]he primary purpose of a forward contract is to transfer ownership of the commodity and not to transfer solely its price risk."[48] The main thrust of the CFTC's swaps regulations concerns transactions designed to shift price risk, in other words, to shift the risk of change in the value of a commodity.[49] It is this shifting of risk that the Dodd-Frank Act was intended to address.

The rule further defining "swap" emphasizes a functional definition of the term. It indicates that, in order to qualify for the Dodd-Frank Act's exemption for forward contracts, a transaction must satisfy a "facts and circumstances" test that centers around "inten[t] to be physically settled—or, perhaps more aptly, intent to *deliver*.[50] The critical analysis for many contracts is thus an exercise in identifying the factors that would tend to make the CFTC more likely to view the contract as one primarily intended for actual delivery of a commodity rather than as one used for financial speculation.

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[44] CEA § 1a(47)(B)(ii), 7 U.S.C. § 1a(47)(B)(ii).
[45] Dodd-Frank Act § 712(d)(1).
[46] Further Definition of "Swap," 77 Fed. Reg. 48,208.
[47] *Id.* at 48,227.
[48] *Id*. at 48,228.
[49] The CFTC states in its final rule:

> As the CFTC has noted and reaffirms today: The underlying postulate of the [forward] exclusion is that the [CEA's] regulatory scheme for futures trading simply should not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity.

Id. citing the "Brent Interpretation," *Statutory Interpretation Concerning Forward Transactions,* 55 Fed. Reg. 39,188 (Sept. 25, 1990).
[50] Further Definition of "Swap," 77 Fed. Reg. at 48,228. Although the NFP EEU requested that the CFTC articulate an industry-wide exemption process for tariff transactions, to be included in the rule defining swap, the CFTC did not do so.

As a threshold matter, only non-financial commodities are eligible for the forward contract exclusion from the definition of swap. The CFTC's final order clarified that the agency interprets the term non-financial commodity to mean "a commodity that can be physically delivered and that is an exempt commodity or an agricultural commodity."[51] (An "exempt commodity" includes electricity as well as natural gas.) The rule further states that although a non-financial commodity must be physically deliverable, it can include intangible commodities such as emissions allowances, that can be embodied in deliverable form such as certificates or entries in an electronic account that can be turned into state regulators or others in satisfaction of environmental obligations.[52] It does not include purely financial transactions such as interest rate swaps or "fixed for floating" electricity swaps, however.

When dealing with the definitional elements, it is probably best to avoid looking to the definitions as strictly circumscribing which transactions are swaps and which are not, because the CFTC has yet to produce something that definitive, and it may be years before there is sufficient case law from which to draw these types of firm conclusions. The better approach is to look at the definitional materials as outlining a continuum of probability, highlighting factors that may make it more or less likely that the CFTC will view a set of circumstances as more or less likely to create systemic risk worthy of regulation. On this continuum, however, intent to make or take delivery of the actual commodity will clearly have crucial importance. The facts and circumstances test that will be used by the CFTC to determine whether the forward contract exclusion applies balances several factors to assess whether the transaction demonstrates an "intent to make or take delivery."[53] While the intent of the parties to deliver or receive a product is the CFTC's core concern,[54] intent is most likely identified through such evidence as contract terms and course of performance (which is necessarily an after-the-fact determination when the contract has been performed for some years). Delivery need not occur in every instance, so long as a transfer of ownership remains the primary purpose under the contract, not shifting price risk.[55] However, because course of performance is one indicator of the parties' intent under a contract, a repeated failure to deliver may adversely impact the analysis of whether a transaction is a swap or a forward contract.[56]

The CFTC's oft-cited *Wright* order, *In re Roger J. Wright*, [2011-2012 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 32,008 (2010) ("*Wright*") (involving hedge-to-arrive contracts with an option-like pricing term) provides the following discussion of how the Commission evaluates intent to deliver:[57]

> In assessing the parties' expectations or intent regarding delivery, the Commission applies a "facts and circumstances" test rather than a bright-line test focused on the contract's terms. While we acknowledged that the language of any written agreement is relevant, both *Grain Land* and *Competitive Strategies* declined to

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[51] Further Definition of "Swap," 77 Fed. Reg. at 48,232 (citations omitted).
[52] *Id*. at 48,233.
[53] *Id.* at 48,229.
[54] *Id.* at 48,228.
[55] *See* Further Definition of "Swap," 77 Fed. Reg. at 48,229; *In re Grain Land Coop.*, [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,636 (2003) (holding that cancellations of delivery without evidence of intent did not by themselves establish a futures contract) ("*Grain Land*").
[56] *See Grain Land*.
[57] *Wright* at 6-7.

> give such language controlling weight in all circumstances. Instead, the cases indicated that in assessing intent, evidence of the parties' course-of-performance conduct under the contract generally would be given at least as much weight as evidence of the words they used to express their agreement. *See Grain Land,* ¶ 29,636 at 55,748; *accord, Competitive Strategies,* ¶ 29,635 at 55,731.

While neither contract terms nor actual performance under a contract may alone be determinative, both are significant factors in the CFTC's analysis of whether a transaction constitutes a swap or a forward. This CFTC approach is of particular concern for transactions where the initial financial logic for entering the transaction has changed over the years. For example, a long-term contract that was originally intended for physical delivery may shift in value over the years to the point where delivery obligations are now routinely settled financially. The intent of the parties in entering a contract ought theoretically to be fixed at the time the contract is signed, although this can be difficult to determine as an objective matter and on a backward-looking basis, particularly if the course of contract performance has become more ambiguous. For this reason, it may be useful to periodically review ongoing contracts, with the CFTC rules in mind.

In emphasizing a functional test rather than a categorical test, the final rule declines to provide absolute certainty as to what falls into what bucket of contracts, such as "non-financial contracts." However, the rule does state that book-outs will not automatically trigger the swaps designation.[58] Although the CFTC makes no categorical exclusions for energy contracts, it specifies in the rule that various types of energy contracts *may* be eligible for the exclusion under one or another test, most commonly the facts and circumstances test that generically applies to all forward contracts.

Energy-related contracts that the CFTC has suggested *may* be eligible for exclusion from regulation as swaps, depending on the facts and circumstances, include:[59]

- Physical transactions settled through book-out transactions,
- EEI form contracts with netting agreements,
- Contracts for environmental commodities including RECs and emission allowances,
- Fuel delivery agreements,
- Full requirements contracts,
- Output contracts,
- Capacity contracts,
- Transmission services agreements,
- Tolling agreements,

[58] Further Definition of "Swap," 77 Fed. Reg. at 48,228- 29.
[59] *See id.* at 48,229-44.

- Evergreen contracts or extension terms,
- Peaking supply natural gas contracts, and
- Power or gas transaction contracts containing liquidated damages provisions.

Some of the examples noted above relate to common contract form transactions that have been used in the energy industry for quite some time. Examples of form agreements commonly used for transactions intended for physical delivery include the Edison Electric Institute ("EEI") agreement, the North American Energy Standards Board ("NAESB") Agreement often used for gas transactions and the Western System Power Pool ("WSPP") Agreement. While the CFTC explicitly references the EEI Agreement,[60] the reference stops short of exempting any transactions using it, and care should be taken with regard to schedules, annexes and individualized terms that can change the nature of the agreement from what the parties intend. Similarly, the form agreements developed by the International Swap Dealers Association ("ISDA") may not be actual swaps, depending on the forms used, even though the name contains the title. The form contracts will be addressed by another presenter in this forum, but the overall message is that it is important to make sure the language reflects intent, and that the parties understand what they are trying to accomplish. We would caution against using the ISDA agreements for anything but transactions that both parties intend to be swaps.[61]

Whether form contracts or individually tailored agreements, the central questions are the same. Even if the contracts are true forward transactions, they may still fall within the swap definition if they include embedded options. Options are swaps.[62] However, under a three-part test spelled out in the rule, forward contracts with embedded optionality will still qualify under the forward contract exclusion if the options: 1) may be used to adjust the forward contract price but do not undermine the overall nature of the contract as a forward contract where physical delivery is intended; 2) do not target delivery terms, so that the predominant feature of the contracts is actual delivery; and 3) cannot be severed or marketed separately from the overall forward contract in which they are embedded.[63]

One of the concerns commenters such as the NFP EEU raised was the problem of transactions where the volume of power delivered could vary, such as full or partial requirements contracts where the load would vary with the weather or time of day. While these are standard in the utility industry, the varying amounts to be delivered look like an option to the CFTC. In response to industry concerns, the CFTC's August 2012 rule proposed, but did not finalize, a seven-part test for transactions with embedded volumetric optionality. This test, if finalized, would presumably apply in lieu of the more generic three-part test described in the preceding paragraph, which applies more generally to contracts with embedded optionality. Under the

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[60] *See*, *e.g.*, *id.* at 48,230 (concluding that netting terms in EEI Master Power Purchase and Sale Agreement are consistent with the Brent Interpretation).

[61] The ISDA contracts are specifically designed for swaps, and though ISDA has annexes for physical transactions, use of the ISDA forms likely carries more risk that a transaction may be viewed as a swap. *See, e.g., id.* at 48,267 (discussing swaps using the ISDA Master Agreement).

[62] CEA § 1a(47)(A), 7 U.S.C. § 1a(47)(A).

[63] Further Definition of "Swap," 77 Fed. Reg. at 48,237.

CFTC's proposal, to avoid the swap label, transactions with volumetric optionality would need to have seven features to avoid swaps regulation:[64]

> 1. The embedded optionality does not undermine the overall nature of the . . . transaction as a forward contract;
> 2. The predominant feature of the . . . transaction is actual delivery;
> 3. The embedded optionality cannot be severed and marketed separately from the overall agreement . . . ;
> 4. The seller of [the] nonfinancial commodity . . . intends . . . to deliver the . . . commodity if the option[] is exercised;
> 5. The buyer of [the] nonfinancial commodity . . . intends . . . to take delivery . . . if it exercises the . . . option[];
> 6. Both parties are commercial parties; and
> 7. The exercise or non-exercise 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 . . . commodity.

The first six factors of this proposed test should not be difficult to address with appropriate contract language. However, the seventh factor is more ambiguous and thus more problematic. Because the seventh factor draws a distinction between optionality exercised for economic (cost) reasons and non-economic (e.g. the weather) reasons, it is much harder to draw the lines in the context of business decision-making, where rational business people ordinarily consider both economic and non-economic factors. It is this seventh factor that can make it very challenging to determine whether a transaction with volumetric optionality would be considered a swap. It is likely industry concern over this seventh factor that has caused the CFTC to fail to finalize this proposed test since the swaps rule was issued in August 2012.[65]

The final rule also makes clear that the CFTC intends to retain the so-called "Brent Interpretation"[66] for forward contracts settled through book-out[67] transactions, and that the agency intends to continue to observe all other prior precedent related to forward contracts. The Brent Interpretation applies to commercial participants in connection with their business where

[64] *Id.* at 48,238 (citations omitted).
[65] However, on September 30, 2013, the CFTC Division of Market Oversight issued responses to Frequently Asked Questions regarding commodity options, restating these seven factors for determining whether a transaction containing embedded volumetric optionality is a forward contract or a swap. CFTC Division of Market Oversight Responds to Frequently Asked Questions Regarding Commodity Options 1-2, https://forms.cftc.gov/_layouts/TradeOptions/Docs/TradeOptionsFAQ.pdf.
[66] The Brent Interpretation has been used by the CFTC to distinguish a forward contract from a futures contract (or swap). Further Definition of "Swap," 77 Fed. Reg. at 48,22829. Key to classifying book-outs as forwards rather than futures has been that "[a]t any point in the chain, one of the parties could refuse to enter into a new contract to book-out the transaction and, instead, insist upon delivery pursuant to the parties' obligations under their contract." *Id*. at 48,229. Also relevant "is that the [book-out] occur through a subsequent, separately negotiated agreement." *Id*. at 48,230. While in the past, the Brent Interpretation applied only to oil, the CFTC will now apply it to all nonfinancial commodities. *Id*. at 48,229-30.
[67] A "book-out" transaction occurs when two parties with a contract for physical delivery enter into a new agreement to settle the old agreement financially instead of through physical delivery.

the parties intend to make or take delivery at the time that they enter into the contract, regardless of whether the parties later book-out. According to the CFTC,[68]

> [i]ntent to make or take delivery can be inferred from the binding delivery obligation for the commodity referenced in the contract and the fact that the parties to the contract do, in fact, regularly make or take delivery of the referenced commodity in the ordinary course of their business.

Other factors include: "demonstrable commercial need for the product, underlying purpose of the contract . . . , the regular practices of the . . . entity with respect to its . . . commercial business . . . , or whether the absence of physical settlement is based on a change in commercial circumstances."[69] Contracts that have renewal options or optionality with regard to delivery points or delivery dates will meet the exclusion for forward contracts if their provisions are in line with the Brent Interpretation—for example, because they require delivery.[70]

D) Caught in the "Swap" Box

If the details of a contract, such as optionality, trigger the swap definition, the next question is whether that swap may be eligible for relaxed treatment under the CFTC's rules. For example, a contract may receive special treatment because it is a trade option, as defined by the CFTC.[71] Swaps carried out by municipal entities most likely would at least be eligible for the end-user exception to the clearing requirement,[72] based on the status of these entities as end-users of electric power and natural gas.

1. Trade Options

The CFTC subjects trade options to a form of swaps regulation "lite." The purpose of exempting trade options from the bulk of swap regulation is to facilitate hedging opportunities for commercial entities, for physically delivered transactions used for purposes related to their business.[73] The CFTC's Division of Market Oversight issued a no-action letter on April 5, 2013 that relieves most end-users from most reporting and certain recordkeeping requirements pertaining to trade options.[74]

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[68] *Id*. at 48,229.
[69] *Id.* at 48,231.
[70] *See id.* at 48,240 & n.359.
[71] Commodity Options, 77 Fed. Reg. 25,320 (Apr. 27, 2012), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-9888a.pdf. *See also* CFTC Division of Market Oversight, *Staff No-Action Relief from the Reporting Requirements of § 32.3(b)(1) of the Commission's Regulations, and Certain Recordkeeing Requirements of § 32.3(b), for End Users Eligible for the Trade Option Exception*, CFTC Letter No. 13-08 (Apr. 5, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-08.pdf (establishing light reporting rules for trade options).
[72] *See* End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560 (July 19, 2012), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-17291a.pdf.
[73] Commodity Options, 77 Fed. Reg. 25,320, 25,326 (Apr. 27, 2012).
[74] CFTC No Action Letter No. 13-08. The no-action letter does not have an end date, though it is expected that the CFTC will issue a final rule on trade options at some point that may affect this exemption.

In order to qualify as a "trade option" rather than a standard commodity option subject to more expansive swaps regulation, a transaction and the parties to that transaction must satisfy a number of conditions. The offeror must be an Eligible Contract Participant ("ECP"), as that term is defined by the CFTC, or alternatively must be 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 be offering or entering into the transaction solely for purposes related to its business as such."[75] As noted earlier, most municipal entities will satisfy one or both standards of this prong of the test. In addition, the offeree must qualify.[76] The offeree need not be an ECP but must also be a "producer, processor, or commercial user," etc. of the commodity at issue.[77] A municipal entity, when serving as offeree, likewise should satisfy this prong. Finally, the third prong of the trade option exemption is that both parties must intend at the time of entering into the contract that the commodity option, if exercised, be physically settled.[78]

Trade options are subject to limited reporting requirements. Trade options that are not otherwise reported to the CFTC (as they would be, for example, where one party is a swap dealer who must report all swaps as a matter of course) should be reported on the Form TO annually, by March 1. The Form TO is a brief form available online.[79]

2. End-User Exception

If a transaction carried out by a municipal entity triggers the swap definition and does not qualify as a trade option, in many cases the end-user exception to the clearing requirement can be elected. The Commodity Exchange Act, as amended by Title VII of the Dodd-Frank Act, establishes a clearing requirement for swaps, providing that "it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing . . . if the swap is required to be cleared."[80] However, Section 2(h)(7)(A) of the CEA provides that the clearing requirement shall not apply to a swap if one of the counterparties to the swap is an end-user. Specifically, the swap is not required to be cleared if one counterparty "(i) is not a financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps."[81] The CFTC issued a final rule on July 19, 2012 that reflects these three requirements for the end-user exception.[82]

As a result, a municipal entity that cannot escape the swap box can determine whether the end-user exception can be elected based on the answer to two questions. The entity must be "a nonfinancial entity, as defined at CEA Section 2(h)(7)(C)(i)" and it must be "using the swap to hedge or mitigate commercial risk."[83] As to the first question, the CFTC grants that "most state and local government entities are not likely to be 'financial entities' under Section

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[75] Commodity Options, 77 Fed. Reg. at 25,326.
[76] *Id.*
[77] *Id*.
[78] *Id*.
[79] CFTC Form TO, *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcformto.pdf.
[80] CEA § 2(h)(1)(A), 7 U.S.C. § 2(h)(1)(A).
[81] CEA § 2(h)(7)(A), 7 U.S.C. § 2(h)(7)(A).
[82] End-User Exception, 77 Fed. Reg. 42,560.
[83] *Id*. at 42,590.

2(h)(7)(C)(VIII)."[84] As to the second, swaps that are "entered into for the purpose of speculating, investing, or trading" will not be eligible for the end-user exception.[85] In addition, the CFTC has not classified all swaps related to physical positions as qualifying hedging. The CFTC has said: "For example, a swap related to physical positions may be a speculative position taking an outright view of the underlying commodity market. In limiting the end-user exception to swaps that hedge or mitigate commercial risk, Congress did not provide an exception from that limitation for swaps related to physical positions."[86] Despite these qualifications, the end-user exception should be available to municipal entities in most circumstances.

In order to take advantage of the end-user exception, it must be elected, and the electing party will need to comply with a number of CFTC regulations. To elect the end-user exception, an end-user must report to a swap data repository ("SDR") a) that it is not a financial entity, b) that it is using any swaps for the purpose of hedging or mitigating commercial risk, c) how it generally meets its financial obligations associated with non-cleared swaps (e.g. its available financial resources, pledged assets, third-party guarantee), and d) that it is not an issuer of securities.[87] The CFTC allows this information to be submitted on a swap-by-swap basis, or on an annual basis (particularly where swap-by-swap reporting is not required).[88]

Although the end-user exception is not as advantageous as treatment as a trade option, it provides relief from some of the most onerous obligations imposed on entities that engage in swaps transactions. Electing entities will need to comply with recordkeeping and reporting requirements found at 17 CFR Part 45, which include recordkeeping related to the end-user exception. The CFTC still has not issued final rules on whether counterparties will have special margining requirements for uncleared swaps with end-users, which may make counterparties more reluctant to engage in these transactions.

III. CONCLUSION

When faced with the question of which transactions will be subject to scrutiny by the CFTC, in the Dodd Frank world, there are a number of considerations, and they do not necessarily lead to the clear answers that market participants would prefer. The progression of questions is fairly obvious, even if the answers are not. The answer reached at the end of the analysis will be most definitive if either the 201(f) exemption or the RTO exemption applies. If these exemptions do not apply, then it will be necessary to wade into an examination of the facts and circumstances to determine whether the transaction is likely to benefit from the forward contract exclusion from the swaps definition, or whether the transaction is a swap that requires further action of some type, such as trade option reporting or election of the end-user exception.

The facts and circumstances analysis necessary to determine whether a transaction is a forward contract or a swap, intrinsically mired in details, is further complicated by the fact that the applicable laws and regulations are new. Although the CFTC states that it will continue to observe pre-existing precedent such as the *Wright* and *Grain Land* cases, fact patterns arising in the energy industry may not always parallel the fact patterns of prior precedent which largely

[84] *See id.* at 42,563.
[85] *Id.* at 42,573.
[86] *Id.* at 42,574.
[87] *See* 17 C.F.R. § 39.6(b), 77 Fed. Reg. at 42,590.
[88] *Id*.

concerns the agricultural commodities. In addition, it is hard to predict where future enforcement actions may lead, particularly in the context of an era when the CFTC and FERC appear to be embroiled in at least jurisdictional posturing, if not out-and-out jurisdictional battle. Finally, the CFTC still has not finalized the test for volumetric optionality, which is a central issue for the electric power industry.