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CFTC

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CLIENT ALERT:

The CFTC Finalizes a More Permissive Interpretation of Embedded Volumetric Optionality in Forward Contracts

The Commodity Futures Trading Commission ("CFTC") has published a final interpretation on volumetric optionality that represents a win for electric and gas utilities transacting in electricity, gas, and related commodities in the course of serving their customers. The interpretation will make it easier for utilities to determine that a contract with "embedded volumetric optionality" is a relatively unregulated "forward contract" rather than a regulated "swap." Although the seven-factor test used for making this determination has not been eliminated, and no particular class of forward contracts is exempted under this interpretation, the CFTC here indicates its intent to apply the test in a way that will be more favorable to many Spiegel clients.

On May 18, 2015, the CFTC, jointly with the SEC, issued a final interpretation on forward contracts that contain embedded volumetric optionality.[1] This interpretation finalizes the amended seven-factor test previously proposed in November 2014. 79 Fed. Reg. 69,073 (Nov. 20, 2014).[2] Specifically, the CFTC has:

- Clarified that the fourth and fifth factors of the seven-factor test do not preclude contracts that provide for delivery of a non-financial commodity within certain minimum and maximum ranges (e.g. "swing contracts" for gas).

- Clarified that the test applies to both puts and calls.

[1] The final interpretation can be found here: 80 Fed. Reg. 28,239 (May 18, 2015).

[2] The November 2014 interpretation was issued in response to industry concerns and affected the CFTC's interpretation of its earlier rule defining swaps, 77 Fed. Reg. 48,207 (Aug. 13, 2012). The purpose of the seven-factor test is to determine whether volumetric optionality contained in a forward contract makes that contract a swap.

- Confirmed that the seventh factor is modified such that the embedded volumetric optionality will not trigger the swaps definition when it is primarily intended, *at the time that the parties enter into the agreement*, contract, or transaction, to address *physical factors or regulatory requirements* that reasonably influence demand for, or supply of, the nonfinancial commodity.

- Explained that a "physical factor" can be construed broadly to include anything that affects supply or demand, including but not limited to weather, location, "operational considerations" (such as availability of transportation or technology), and "broader social forces, such as changes in demographics or geopolitics."[3]

- Indicated that hedging against price risk, which normally would trigger the "swaps" definition, will not by itself make a forward contract a swap where the hedging party is subject to some type of "requirement" or "guidance," whether "formal or informal," from a regulatory commission or similar governing body, to obtain (or provide) lowest-cost energy (e.g. the buyer is an energy company regulated on a cost-of-service basis).

- Specified that demand response agreements, even if not mandated by a system operator, may be characterized as the product of "regulatory requirements" within the meaning of the seventh factor.

As the CFTC applies a facts and circumstances test to each transaction, the outcome of the seven-factor test in any particular case remains fact-specific. Nevertheless, this interpretation should significantly reduce the likelihood that municipal utilities will fall afoul of the CFTC swaps regime due to embedded volumetric optionality, including optionality in the volume term of a contract for power. Most of our clients are regulated by City Councils or other local government agencies on a cost-of-service basis (consistent with reliability, environmental, and rate stability goals). It is worth checking the governing standard for your rates to be certain that the goal of keeping rates low (consistent with other needs) is explicit.

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[3] The interpretation also clarifies that the fact that a party to the contract may have some influence over these facts and circumstances will not by itself disqualify the agreement from being an exempt forward contract.