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Global Energy & Infrastructure | Alert

April 2016

CFTC Proposed Guidance States Capacity and Peaking Supply Contracts are not Swaps

On April 4, 2016, the U.S. Commodity Futures Trading Commission (CFTC) issued certain proposed guidance (the Proposed Guidance) on the treatment of capacity contracts and peaking supply contracts related to the supply and delivery of electric power and natural gas (the Contracts). Pursuant to that Proposed Guidance, CFTC would not treat electric power capacity contracts and natural gas peaking supply contracts as swaps.

Capacity contracts are commercial agreements that allow the purchaser to ensure it has sufficient capacity to deliver an underlying energy product to consumers on demand as needed. These contracts are used in situations where regulatory requirements issued by state public utility commissions obligate utilities to purchase power capacity from suppliers to secure power grid management and on-demand deliverability of power to consumers. Similarly, peaking supply contracts are contracts entered into by electric utilities that allow the utility to purchase natural gas from other natural gas providers during times when its normal supply is interrupted or curtailed during certain permissible specified conditions. Neither Contract serves as a hedge or for price speculation purposes. Rather, power suppliers utilize the Contracts to meet obligations pursuant to federal or state regulations.

Both types of Contracts are entered into by commercial market participants with the contemplation of physical settlement of the transactions, which is triggered by regulatory requirements and the need to maintain sufficient supplies. CFTC proposes to consider both types of Contracts to be "customary commercial arrangements" that are thereby excluded from the definition of a swap pursuant to an interpretation previously issued by CFTC and SEC. This determination was based on the fact that the Contracts are "closely tied to regulatory obligations in the markets for electric power and natural gas."

The Proposed Guidance explains further that the Contracts are not swaps because they are not traded on an organized market or over-the-counter, and the Contracts do not have severable payment obligations. Additionally, the CFTC notes that the Contracts are entered into by "commercial entities…as principals to serve an independent commercial, business, or non-profit purpose, and other than for speculative, hedging, or investment purposes." Therefore, the CFTC does not classify the Contracts as swaps.

CFTC also noted that the Proposed Guidance would not affect whether the Contracts should be considered forward contracts. CFTC had previously issued a Final Rule that set forth circumstances under which nonfinancial commodity contracts with "embedded volumetric optionality," *i.e.,* that provide for variations in delivery amount, may be considered forward contracts that are not subject to swaps regulation. Because the Contracts may be considered such forward contracts, the CFTC specifically stated that the Proposed Guidance would not alter or affect the seven-part test set forth in that Final Rule.

CFTC's Proposed Guidance is designed to go hand-in-hand with its recently-adopted Final Rule regarding trade options, which are commodity options purchased by commercial users of the commodities underlying the option. This Final Rule significantly reduced the number of rules to which trade options are subject, including position limits, recordkeeping requirements, and certain notice filings and year-end activity reporting requirements. Of course, trade options remain subject to the Commodity Exchange Act's antifraud and anti-manipulation requirements.

CFTC Chairman Timothy G. Massad noted that CFTC issued this Proposed Guidance after considering "useful input" from "market participants expressing concerns about this issue," noting that the Proposed Guidance "will properly clarify the treatment of contracts used by many businesses with respect to the supply and delivery of electric power and natural gas." Specifically, Chairman Massad acknowledged that the Contracts are designed "not to hedge against risks arising from a future change in price of [a] commodity or for speculative, investment purposes," but rather are entered into "in response to regulatory requirements, the need to maintain reliable energy supplies, and practical considerations of storage and transport."

The full text of the Proposed Guidance may be found here. Comments to the Proposed Guidance are due thirty days after its publication in the Federal Register. CFTC will accept comments on all aspects of the Proposed Guidance, and requests comments on certain specific matters, including:

> Whether there exist any natural gas or power contracts that would be covered by the Proposed Guidance, but are not considered "trade options" as described above.

> Whether the Proposed Guidance provides sufficient clarity on whether the Contracts should or should not be considered swaps, and why.

> Whether CFTC should consider facts and circumstances, other than those articulated in the Proposed Guidance, regarding whether the Contracts should or should not be considered swaps.

> Whether there are other types of contracts that are similar to the Contracts that should also be considered for similar guidance.

> Whether any public interest concerns should be reflected in the Proposed Guidance.

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