



NEWS

For Immediate Release: February 21, 2013

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Energy Users Ask CFTC to Grant “No-Action” Relief for Notional Amount Methodology

(Washington, D.C.) -- Today the Natural Gas Supply Association (NGSA), joined by the Electric Power Supply Association, asked the Commodity Futures Trading Commission (CFTC) to grant “no-action” relief on methodologies used to calculate the notional amount of certain commodity swaps.

Jenny Fordham, NGSA’s vice president, markets, said, “We’re asking the CFTC to confirm that it won’t recommend an enforcement action against a market participant that calculates the notional amount of its swaps in a way that is consistent with its understanding of industry practice or another commercially reasonable method in the absence of additional formal regulatory guidance.”

According to NGSA’s comments, the notional amount of certain swaps will be used to determine whether an entity must register as a Major Swap Participant or whether it exceeds the Commission’s *de minimis* threshold and must register as a Swap Dealer. Last year, NGSA and EPSA were part of a coalition that recommended a specific methodology for calculating notional amount that would have provided clear guidelines and greater regulatory certainty.

The CFTC’s entity definition final rule contemplates the use of “standard industry practices” for calculating notional amount of swaps; however some instruments do not have a uniform industry standard because of their specialized nature. Further confusing the matter, at least two conflicting methods for calculating the notional amount of swaps exist in separate CFTC documents. These are cited in NGSA’s comments. (See following pages for the comments.)

Jenny Fordham, NGSA’s vice president, markets, said, “In light of the somewhat conflicting guidance, market participants face the risk that the CFTC may disagree after the fact with the methodology used to calculate notional amount. We’re requesting no-action relief so that market participants can have the confidence that, in the face of regulatory uncertainty, a reasonable decision can be made for compliance.”

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NGSA represents integrated and independent companies that supply natural gas. Established in 1965, NGSA encourages the use of natural gas within a balanced national energy policy, and promotes the benefits of competitive markets to ensure reliable and efficient transportation and delivery of natural gas and to increase the supply of natural gas to U.S. customers. For more information, please visit www.ngsa.org.

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*Commodity Exchange Act Section 1a
Commission Regulation 1.3(ggg) and 1.3(hhh)*

Via Hand Delivery and Electronic Mail

Gary Barnett, Director
Division of Swap Dealer and Intermediary Oversight
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Calculation of Notional Amount

Dear Mr. Barnett:

Pursuant to CFTC Rule 140.99, the Natural Gas Supply Association (“**NGSA**”) and the Electric Power Supply Association (“**EPSA**”) (collectively, “**the Associations**”) request that the Division of Swap Dealer and Intermediary Oversight (“**DSIO**”) of the Commodity Futures Trading Commission (“**CFTC**” or “**Commission**”) issue no-action relief regarding the methodologies used to calculate notional amounts for purposes of swap dealer (“**SD**”) and major swap participant (“**MSP**”) registration requirements (collectively “**SD/MSP Thresholds**”).¹ Specifically, the Associations ask DSIO to confirm that it will not recommend an enforcement action against a market participant that applies a methodology consistent with and based upon the market participant’s understanding of industry practice or, to the extent there is no uniform industry practice, another commercially reasonable method, absent publically available formal guidance from DSIO or the CFTC directed to the calculation for particular products.

I. Application Of Notional Amount To SD And MSP Threshold

Under the CFTC’s swap dealer analysis, market participants must aggregate the gross notional amount of dealing swaps executed by the market participant and any affiliate controlling, controlled by or under common control with the market participant, over the prior 12 months.² Once a market participant exceeds a swap dealing *de minimis* threshold, the entity

¹ See 17 C.F.R. § 140.99.

² Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant”, 77 Fed. Reg. 30596, 30631 (May 23, 2012) (“**Entities Final Rule**”).

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must register as an SD no later than two months following the end of the month in which it first exceeded a threshold (“**SD Grace Period**”).³

For the CFTC’s MSP analysis, market participants must determine the notional value of their swaps activities. For example, in order to determine if a market participant has a “substantial position” in a major swap category requiring it to register as an MSP, it must determine if the daily average of the sum of the current uncollateralized exposure, plus the potential future exposure associated with its swap positions in any major swap category in a calendar quarter exceeds certain amounts. To determine potential future exposure, a participant must calculate the notional value of certain swap positions, applying the risk multiplier set forth in the CFTC regulations.⁴ Once a market participant exceeds an MSP threshold, it must register as an MSP no later than two months following the end of the quarter in which it first exceeds a threshold (“**MSP Grace Period**”).

The Final Entities Rule does not prescribe particular methodologies for calculating the gross notional amount or effective notional amount. Instead, the Commission has stated that it “contemplates[s] the use of standard industry practices”.⁵ In efforts to determine which methodologies the commission would consider acceptable, market participants have contacted the staff informally and presented specific examples. However, we have not received clear, consistent guidance.

II. The Combination of Insufficient and Conflicting Guidance Creates Unnecessary Risk for Market Participants

A. DSIO Frequently Asked Questions

On October 12, 2012, DSIO published a “frequently asked questions” document (“**DSIO Guidance**”), which included a methodology for the calculation of the notional amount for locational basis swaps, collars and swaptions.⁶ As part of the guidance, DSIO explained that the notional amount for locational basis swaps referencing one physical commodity is the difference

³ Currently, there is an \$8 billion *de minimis* threshold for swap dealing transactions with market participants generally, with a lower \$25 million *de minimis* threshold for swap dealing transactions with special entities. Exceeding either threshold triggers swap dealer registration. *See* CFTC Rule 1.3(ggg)(4)(i).

⁴ 77 Fed. Reg. at 30663.

⁵ CFTC Rule 1.3(ggg)(4) & (jjj)(3)(iii)(A)(2); and 77 Fed. Reg. at 30670 n. 902 (“As is the case for measuring current exposure, the final rules do not prescribe any particular methodology for calculating the notional amount or effective amount used in the calculation of potential future exposure, but instead contemplate the use of industry standard practices”).

⁶ *See* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/swapentities_faq_final.pdf.

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in the fair market value of the commodity at the two locations, multiplied by the number of units referenced in the swap. DSIO also directed market participants to determine the notional amount of a swaption by “looking-through” the option and calculating the notional amount of the underlying swap.

However, the DSIO Guidance did not address a number of other derivatives common in the energy industry. For example, the guidance did not address many float-for-float swaps such as index spreads, inter-commodity spreads, and calendar spreads.⁷ The Associations believe that it is reasonable to apply the DSIO Guidance regarding the calculation of locational basis swaps to the calculation of other float-for-float swaps.

Similarly, the DSIO Guidance did not address what methodology should be used to calculate the notional amount for commodity options. As a result, it is unclear whether market participants should “look-through” the option to the value of the underlying commodity, use the price of the premium, or develop some other reasonable methodology. The Associations believe it is normal practice within the energy industry to multiply the transaction price of the option (that is, the option premium) by the quantity of the option, to calculate the notional amount, and, accordingly, market participants should be able to rely on this method.⁸

B. The Part 20 Swaps LTR Guidebook

Separately, the CFTC provided guidance on the calculation of swap notional value in the Part 20 swaps large trader reporting rule (“**Swaps LTR**”). For this rule, the CFTC’s Division of Market Oversight (“**DMO**”) developed, but did not publish for public comment, a Swaps LTR reporting guidebook (“**Swaps LTR Guidebook**”) that includes guidance on reporting notional values for certain products such as locational basis swaps.⁹ In the Swaps LTR Guidebook, the DMO instructed market participants to calculate separately the notional value of each leg of a location basis swap. However, this notional value calculation differs from the approach outlined in the DSIO Guidance for purposes of determining the *de minimis* SD threshold, which instructs market participants to calculate the difference in the fair market value of the commodity at the

⁷ In an index spread, a counterparty exchanges the price of an index for the price of a different index. In an inter-commodity spread, payments are based on the difference between the price of one commodity and the price of a different commodity. In a calendar spread, the payments are based on the spread value between two different delivery periods, typically for the same commodity.

⁸ For a discussion of industry practice for several instruments common in the energy industry, *see e.g.*, Letter from the American Petroleum Institute, Commodity Markets Council, Edison Electric Institute, Electric Power Supply Association, Independent Petroleum Association of America and Natural Gas Supply Association, (“**Coalition Letter**”), to David Stawick, Secretary, Commodity Futures Trading Commission (Sep. 20, 2012) (on file with the Commodity Futures Trading Commission).

⁹ *See* <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/ltrguidebook053112.pdf>

two locations, and multiply the difference by the number of units referenced in the swap.¹⁰ In addition, staff has stated to market participants informally that the Swaps LTR Guidebook is for reporting purposes only and should not be viewed as guidance for SD and MSP notional calculations. As a result, market participants cannot rely upon the notional value methodologies in the Swaps LTR Guidebook when calculating the SD/MSP thresholds.¹¹

C. Reasonable Assumptions In The Absence Of Guidance

In the absence of formal guidance from DSIO or the CFTC, market participants have had to make reasonable assumptions based on their understanding of industry practice in order to calculate the notional amount of their swaps and commodity options. In an attempt to reduce uncertainty about the CFTC's expectations, on September 20, 2012, a number of energy trade associations formally requested CFTC comment regarding their understanding of industry practice for calculating the notional values of certain energy products.¹² The DSIO Guidance regarding locational basis swaps, which was issued subsequent to that request, is consistent with the methodology specified in the Coalition Letter. However, the CFTC did not address any of the calculations for the other products described in the Coalition Letter.

Moreover, there are certain instruments for which there is no uniform industry standard because the instruments present unique challenges in terms of calculating notional value. For example, in some float-for-float swaps, either one or both legs may settle against prices that are not observable at the time the transaction is executed. Given the specialized nature of such instruments, there may be no industry consensus on valuation, and companies, by necessity, will rely on their own commercially reasonable valuation methodologies, which in some cases might preclude calculation of notional value at the time of execution.

In light of this lack of and, in some instances, conflicting guidance, market participants face the risk that the CFTC may, after the fact, disagree with the methodologies employed a risk to which no market participant should in fairness be exposed. To alleviate this burden, the Associations request that the CFTC issue the below outlined relief until such time, if any, that DSIO or the CFTC makes publicly available guidance addressing this issue.

¹⁰ By comparison, the Swaps LTR Guidebook does not rely on the spread to calculate the notional value of a locational basis swap, but instead instructs reporting parties to calculate the notional value for each leg of the swap. *See* Swaps LTR Guidebook at 48.

¹¹ Additionally, the Commodity Pool Operator alternative net notional test under CFTC rules 4.13 and 4.5. ("CPO Rules") directs market participants to calculate the notional value using a formulation based on the strike price. This is inconsistent with the Swaps LTR Guidebook, which uses a formulation based on the price of the underlying commodity. *See* CFTC Rule 4.5(c)(2)(iii)(B) and CFTC Rule 4.13(a)(3)(ii)(B)(1).

¹² *See* Coalition Letter.

III. No-Action Relief

The Associations request that DSIO grant no-action relief providing that it will not recommend commencement of an enforcement action against a market participant that applies a methodology consistent with and based upon the market participant's understanding of industry practice or, to the extent there is no uniform industry practice, another commercially reasonable method, absent publically available formal guidance from DSIO or the CFTC directed to the calculation for particular products.

This request for no-action relief is consistent with prior statements of DSIO regarding how market participants should determine whether a swap should be included in a SD/MSP threshold calculation. Specifically, the DSIO Guidance provides that "the [DSIO] does not anticipate that it would recommend that the Commission take an enforcement action against a [SD or MSP] that, during the period through December 31, 2012, is following its internal policies and procedures that are reasonably designed to ensure that all swaps are appropriately classified for purposes of calculating the [SD and MSP thresholds]." In addition, as noted above, reliance on industry practices for the calculation of notional amounts is consistent with the CFTC guidance in the Entities Final Rule.¹³

In the event that the provides publically available formal guidance with respect to how to calculate the notional value for a particular type of product, market participants should only be required to apply the guidance to swaps executed after the date the guidance is made available. The guidance should not be applied retroactively and should not require market participants to recalculate swaps entered into prior to the date of any CFTC or DSIO guidance. In addition, should the CFTC or DSIO provide guidance or promulgate rules on the calculation for certain products, but not others, market participants should be able to continue to rely on industry practice or other commercially reasonable methodologies for any products the CFTC or DSIO guidance does not address.

As an example, if DSIO or the CFTC publishes guidance on April 1, 2013, market participants would only be required to apply any new methodologies to swaps executed after April 1, 2013 that are covered by the guidance. The Associations also request that if a market participant exceeds an SD/MSP threshold as a result of applying a published methodology after April 1, 2013, the SD/MSP grace period should commence on such date after the publication of the guidance. The Associations respectfully submit that, notwithstanding good faith and diligent efforts to prepare for registration, market participants will not be able to timely perform the new calculations and potentially prepare for registration without these transition measures.

¹³ *Supra* note 6.

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For the foregoing reasons, NGSAs and EPSAs respectfully request that the CFTC or DSIO grant the requested no-action relief.

We hereby certify that the material facts set forth in this letter are true and complete to the best of our knowledge, information, and belief.¹⁴

Respectfully submitted,



Jennifer B. Fordham



Melissa M. Mitchell

cc: Honorable Gary Gensler, Chairman
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O'Malia, Commissioner
Honorable Mark P. Wetjen, Commissioner
Eric Juzenas, Senior Counsel to the Chairman
Dan Berkovitz, General Counsel
Richard Shilts, Acting Director, Division of Market Oversight
Frank Fisanich, Chief Counsel
Ward Griffin, Associate Chief Counsel
Mark Fajfar, Assistant General Counsel
Jeffrey Burns, Assistant General Counsel

¹⁴ In addition, we hereby agree that, if any time prior to issuance of a no-action letter, any material statement made in this letter ceases to be true and complete, we will ensure that Commission Staff is informed promptly in writing of all materially changed facts and circumstances.