



NEWS

For Immediate Release: June 20, 2013

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Natural Gas and Corn Associations Ask Senate for a Legislative Fix to Ensure Certain Physical Forward Contracts Are Not Designated "Swaps"

(Washington, D.C.) -- Today the Natural Gas Supply Association (NGSA), joined by the National Corn Growers Association, asked the Senate Agriculture Committee for a legislative fix that ensures that certain forward contracts for physical delivery of corn, natural gas or other commodities are not treated as swaps simply because these contracts preserve a degree of flexibility in the final amount of the commodity to be delivered.

According to the associations, current regulatory language is ambiguous and leaves the door open for forward contracts with this kind of flexibility to be incorrectly classified as swaps. When the Senate Agriculture Committee takes up reauthorization of the Commodity Futures Trading Commission (CFTC), NGSA and NCGA want the committee to modify the Commodity Exchange Act to ensure that forward contracts with volumetric flexibility are treated like other physical forward contracts.

Jenny Fordham, NGSA's vice president, markets, said, "Every day many industries rely on forward physical contracts that have some flexibility about the volume to be ultimately delivered. This flexibility is necessary to reflect fluctuations in production or consumption, changes in economic conditions and measurement tolerances, and it allows the contracts to be settled in an efficient, orderly fashion even when the precise amount of the volume to be delivered cannot be perfectly predicted in advance." She said, "These contracts are not 'options' and they are certainly not 'swaps.'"

Fordham said, "Flexibility about delivered options is a critical tool used to address the uncertainty inherent in any physical commodity contract. It allows commercial market participants to adjust delivery volumes seamlessly in response to changes in supply and demand requirements at the time of delivery. It's essential to classify them correctly as forward contracts, and to remove them from the scope of the CFTC's swap rules. Getting the swap definition right is the heart and soul of Dodd-Frank's end-user protections."

In their comments, NGSA and NCGA warned that the Commission has created so much ambiguity around the treatment of these contracts that market participants may be reluctant to use volumetric flexibility in their forward contracting, making transactions clumsy and compromising the efficiency of the physical market.

The letter to the Senate Agriculture Committee follows. (See next pages.)

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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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The Honorable Debbie Stabenow
Chairwoman
Senate Committee on Agriculture
328A Russell Senate Building
Washington, DC 20510

The Honorable Thad Cochran
Ranking Member
Senate Committee on Agriculture
328A Russell Senate Building
Washington, DC 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

The National Corn Growers Association (NCGA) and the Natural Gas Supply Association (NGSA) appreciate the opportunity to provide input to the Committee as you prepare to review the Commodity Exchange Act (CEA) and reauthorize the Commodity Futures Trading Commission's (CFTC) oversight of the futures and swaps markets.

Founded in 1957, the National Corn Growers Association represents more than 38,000 dues-paying corn farmers nationwide. NCGA and its 48 affiliated state organizations work together to create and increase opportunities for their members and their industry.

Established in 1965, NGSA represents integrated and independent companies that produce and market approximately 40 percent of the natural gas consumed in the United States. 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. consumers.

Because of the potential for the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act or the Act) to impede what are and have been healthy, competitive, and resilient corn and natural gas markets, NCGA and

NGSA played an active role in the shaping of the Act during its passage and have continued this role in ensuring the Act's successful implementation by the CFTC.

The CEA as amended by the Dodd-Frank Act excludes forward contracts and includes options in commodities in the definition of "swap." This raises the practical question of how to treat forward contracts containing terms that provide for some form of flexibility in delivered volumes, i.e., "embedded optionality."

Flexibility in the terms of physical commodity forward contracts is essential in everyday commerce given the commercial uncertainties that exist in commodity delivery and receipt. One important form of such flexibility involves the volumes to be transacted in a forward contract. This flexibility is necessary because parties cannot always accurately predict the required or optimal amounts of physical commodities to meet their business needs and objectives. The CFTC refers to this flexibility as "volumetric optionality" and has formulated rules that suggest that the CFTC will regulate forward contracts with such "optionality" as swaps.

Volumetric optionality is a contractual tool used in the physical commodity industry to "right size" physical delivery. The ability to appropriately size a physical commodity delivery via a contractual tool facilitates market efficiency because it allows commercial market participants to adjust delivery volumes seamlessly in response to changes in supply and demand requirements at the time of delivery. Volumetric optionality is a delivery tool that mitigates the uncertainty inherent in any physical commodity contract, making both parties aware of potential delivery variability embedded within the intent to deliver. Thus, volumetric optionality in a physical forward contract allows commercial uncertainties to be accommodated up front, providing a process for orderly physical delivery and settlement even in the absence of precision in the delivery volume. Importantly, the intent to physically deliver remains despite the variability in final delivery terms.

Last summer, the CFTC issued the final rule further defining the term "swap," Final Rule, *Further Definition of "Swap," et al.*, 77 Fed. Reg. 48, 208 (August 13, 2012) (Swap Definition Final Rule or Final Rule). As part of the definition of swap, the Final Rule provides an interpretation that an agreement, contract or transaction with embedded optionality falls within the forward exclusion when seven criteria are met. The seventh criterion or element requires that:

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 nonfinancial commodity.

In the Final Rule, the Commission specifically requested comments on whether this seventh element is necessary, appropriate and sufficiently clear and unambiguous. On October 12, 2012, NCGA and NGSAs submitted written comments to the CFTC highlighting the market uncertainty that the new seven-criterion test creates in light of very clear statutory language stating that contracts with the intent to physically deliver are physical forward contracts. (See attached.) Specifically, NCGA and NGSAs asked the Commission to affirm that the seven criteria identified in the Final Rule are simply illustrative of certain common characteristics in forward contracts with embedded optionality, and thus, a safe harbor instead of requirements for satisfaction of the forward contract exclusion.

NCGA and NGSAs recognize the Commission's interest in retaining the ability to regulate physical contracts with embedded options as swaps if the "intent to physically deliver" is not genuine and simply crafted to evade regulation.* However, in this case, the Commission has created so much ambiguity in the applicability of the forward-contract exclusion that market participants may be reluctant to use volumetric optionality in their forward contracting. Consequently, the regulatory uncertainty caused by the seven-criterion test compromises the viability of a physical commodity market delivery tool that is critical to market efficiency. The forward-contract exclusion should not be implemented in a way that limits its usefulness to catching bad actors at the expense of physical market efficiency.

The definition of swap has far-reaching effects beyond physical market efficiency. Determining what is and is not a swap impacts the calculation of notional amount and thus, which entities are swap dealers. It also impacts the application of position limits and the appropriate scope of the bona fide hedge exemption, clearing requirements, reporting requirements and capital and margin requirements. In short, the definition of swap is the heart and soul of the end-user protections.

The October 12, 2012 NCGA and NGSAs request for clarity regarding the Commission's expected application of the seven-criterion test remains unanswered. In light of the lingering uncertainty created by the seven-criterion test, clarity regarding the applicability of the forward-contract exclusion to volumetric options embedded within a physical contract has become essential to commodity producers and consumers. Given the importance of the definition of swap to implementation of so many other Dodd-Frank-Act-related CFTC regulations, clarity is crucial to the sound implementation of the Dodd-Frank Act. NCGA and NGSAs suggest that Section 1a(47)(B)(ii) of the CEA (the forward-contract exclusion) should be amended to read as follows:

*The anti-manipulation authority provided by the Dodd-Frank Act is the Commission's tool for ensuring markets that are free of manipulation.

“any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled, including any stand-alone or embedded option for which exercise results in a physical delivery obligation.”

The swap definition is fundamental to implementation of the CFTC’s new Dodd-Frank rules and consequently to the on-going availability of cost-effective risk management tools. However, if the definition is too broad, it can bring in common commercial agreements that have no relationship to the types of transactions that Dodd-Frank was intended to regulate. Market participants demonstrating the potential to exercise physical delivery or a history of physical delivery must have confidence in the forward-contract exclusion from the definition of a swap. NCGA and NGSA are committed to working with you to achieve a positive outcome that both protects the integrity of commodity markets and ensures the continued availability of cost effective hedging tools.

Sincerely,

National Corn Growers Association
Natural Gas Supply Association

Attachment