May 11, 2015

The Honorable Michael Conaway
Chairman
House Committee on Agriculture
1301 Longworth House Office Building
Washington, DC 20515

The Honorable Collin C. Peterson
Ranking Member
House Committee on Agriculture
1010 Longworth House Office Building
Washington, DC 20515

DELIVERED VIA ELECTRONIC MAIL

Dear Chairman Conaway and Ranking Member Peterson:

As the House prepares to vote on and reauthorize the Commodity Futures Trading Commission (CFTC) oversight of the futures and swaps markets, the National Corn Growers Association (NCGA) and the Natural Gas Supply Association (NGSA) wish to express support for the end user provisions in the CFTC reauthorization bill which will help to ensure that corn and natural gas markets are able to function efficiently.

Specifically, NCGA and NGSA support the provision which will provide relief for end-users using physical contracts with volumetric optionality and ensure that non-financial, physical energy delivery agreements are not regulated as swaps.

Founded in 1957, NCGA represents more than 40,000 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 encourages the use of natural gas within a balanced national energy policy, and promotes the benefits of competitive markets, thus encouraging increased supply and the reliable and efficient delivery of natural gas to U.S. customers.

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.

In August of 2012, 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 NGSA 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. Specifically, NCGA and NGSA 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 NGSA 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 NGSA 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 the Dodd-Frank Act. This regulatory uncertainty has complicated the

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

sound implementation of the Dodd-Frank Act and risks harming commodity market efficiency. The CFTC is contemplating some clarifying language on volumetric optionality which would be welcome news. Regardless of the CFTC's clarification, however, the implementation uncertainty that has persisted for the last four years illustrates the need for legislative changes.

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 the Dodd-Frank Act 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

Copy: The Honorable Austin Scott, Chairman, House Subcommittee on Commodity Exchanges, Energy and Credit
The Honorable David A. Scott, Ranking Member, House Subcommittee on Commodity Exchanges, Energy and Credit