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CFTC Proposes Exclusion of Certain Electric Power and Natural Gas Contracts From 'Swap' Definition

On April 4, 2016, the Commodity Futures Trading Commission (CFTC) proposed guidance that would exclude certain capacity contracts in electric power markets (capacity contracts) and natural gas peaking supply contracts from the "swap" definition in the Commodity Exchange Act (CEA).[1] The proposed guidance is based on the CFTC's 2012 joint rulemaking with the Securities and Exchange Commission (SEC, and collectively with the CFTC, the Commissions) further defining "swap" and "security-based swap," among other terms (Swap Definition Rulemaking).[2]

In the Swap Definition Rulemaking, the Commissions discussed characteristics common to certain customary agreements entered into by commercial or nonprofit entities that would be excluded from the swap and security-based swap definitions.[3] The Commissions noted that certain sales, servicing and distribution arrangements, including contracts for the purchase of equipment or inventory, generally would satisfy these characteristics.[4] Under the proposed guidance, the CFTC states its preliminary belief that the following types of capacity and peaking supply contracts — which generally are entered into to ensure supply or service availability in the future based on regulatory requirements and not to hedge against future price fluctuations in the underlying commodity — are similar in nature to those purchase and service contracts described in the Swap Definition Rulemaking and, therefore, would be excluded from the swap definition:[5]

Capacity Contracts. In general, these contracts are used by load-serving entities (LSEs) to purchase additional resources needed to secure grid management and on-demand

[1] *See* Commodity Exchange Act (CEA) § 1a(47)(A). The proposed guidance can be found on the CFTC website: http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister040416.pdf ("Proposed Guidance"). The proposed guidance was issued jointly with the Securities and Exchange Commission.

[2] *See* Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule, 77 Fed. Reg. 48208 (Aug. 13, 2012) . For more information about the Swap Definition Rulemaking, please see Skadden's client alert: http://www.skadden.com/insights/cftc-and-sec-adopt-rules-defining-swap-and-security-based-swap.

[3] *See* Swap Definition Rulemaking, 77 Fed. Reg. at 48246-48248. The Commissions' discussion also included certain customary consumer transactions. *See id.* The characteristics common to any agreement qualifying for the commercial and nonprofit exclusion included: (1) the agreement does not contain payment obligations that could be severed from the agreement; (2) the agreement is not traded on an organized market or over-the-counter; and (3) the agreement is entered into by commercial or nonprofit entities as principals (or by their agents) to serve an independent commercial, business or nonprofit purpose other than speculative, hedging or investment purposes. *See id.*

[4] *See id.* at 48247.

[5] *See* Proposed Guidance at *13-14.

deliverability of electricity to consumers, as mandated by the LSEs' state public utility commissions.[6] The initial payment made under these capacity contracts differs from a commodity option premium in that it normally covers the entire cost of producing, generating and transmitting the electric power to the capacity purchaser, regardless of whether the purchaser ever calls upon the electricity to be delivered.[7] The purchaser, therefore, does not treat the contract as a hedge, but rather as a purchase of an additional supply of electricity to ensure regulatory compliance.[8]

Peaking Supply Contracts. These natural gas peaking supply contracts are used by electric utilities to secure natural gas needed to fuel general facilities in the event transportation service from its primary gas distributor, sometimes referred to as a local natural gas distribution company (or LDC), is interrupted due to regulatory restrictions.[9] Peaking supply contracts cannot be financially settled, and gas supplied under such contracts cannot be resold.[10] Additionally, the price paid under the contract is based on the current market value of fuel at a specific delivery point.[11]

In addition to requesting general comments, the CFTC has solicited responses to specific questions, such as whether the proposed guidance should be limited to contracts that qualify as trade options, and whether other contracts (inside or outside of the electric power and natural gas markets) closely tied to compliance with regulatory frameworks should be considered. The public comment period for the proposed guidance will close 30 days after it is published in the Federal Register.

[6] *See id.* at *4.
[7] *See id.* at *5-6.
[8] *See id.* at *5.
[9] *See id.* at *7.
[10] *See id.* at *8.
[11] *See id.*