Dodd-Frank Act Implementation: Issues for Energy and Commodity Traders

Brought to you by Winston & Strawn’s Energy Practice Group.
Today’s eLunch Presenters

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FERC Regulation of Financial Trades

- FERC historically did not attempt to regulate financial transactions such as futures contracts.
- In 1996, FERC disclaimed jurisdiction over NYMEX trades so long as the contracts do not go to physical delivery (74 FERC P 61,311).
FERC Regulation of Exchanges

- FERC also held that computerized bulletin boards where buyers and sellers can transact are not jurisdictional, as long as the exchange does not establish the price at which the commodity is sold (Continental Power Exchange, 68 FERC P 61,235)

- But, exchanges that establish market clearing prices for physical energy are jurisdictional (Automated Power Exchange, 84 FERC P 61,020)
Changing FERC Regulation

- As FERC has encouraged financial hedging, its interest in regulating financial trades has grown
  - FERC rulemaking Orders 888 and 2000 encouraged the formation of regional transmission and power markets through Independent System Operators (ISO) and Regional Transmission Organizations (RTO)
  - ISOs and RTOs administer multi-utility tariffs across large regions to transmit, buy and sell power at wholesale

- FERC believes that locational marginal pricing of transmission promotes efficiency
Hedging LMPs

ISOs and RTOs that use the LMP method also offer hedging instruments that have

- A revenue right component (generally referred to as a congestion revenue right or CRR) and
- A price hedge component (a financial transmission right or FTR)

The CRR holder can keep the associated FTR and hedge the congestion price risk of its own transactions, or auction off the FTR component
Credit in Organized Markets

- FERC Order 741 establishes uniform credit requirements across RTOs through tariffs to be filed by September 30, 2011 (to be effective January 1, 2012)

- The new credit requirements cap unsecured credit at $50 million per corporate family and prohibit the use of unsecured credit for ARR/FTR transactions

- ARR/FTR transactions must be either secured or backed by collateral (parent guarantees are not acceptable security)
ARR/FTR Credit Risks

- Valuations can fluctuate widely due to transmission line outages, weather or changing load patterns
- ARR/FTRs can become illiquid if they are out-of-the-money
- For these reasons, FERC rejected arguments for exemptions or netting of ARR/FTR obligations against non-ARR/FTR positions
- RTOs, however, can consider the purpose of the ARR/FTR to determine collateral requirements (e.g., an LSE hedging transmission to serve load vs. speculative trading)
RTO Role in ARR/FTR Transactions

- FERC clarified that RTOs are the central counter-party to all ARR/FTR transactions
- This status allows the RTO to assert set-off rights in the event of market participant bankruptcy
- RTOs will also be permitted to propose minimum eligibility requirements to trade ARR/FTRs (e.g., minimum capitalization, trading expertise, etc.)
Are FTRs Futures Contracts?

- The value of the FTR component depends on market expectations about future congestion costs, which are driven by fuel cost expectations.
- In other words, FTRs look like financially-settled futures contracts.
Who Regulates FTRs?

- FERC believes FTRs are squarely within its core jurisdiction because they are a key element of transmission pricing in filed tariffs
- The CFTC has also expressed an interest in regulating FTRs
- FERC and the CFTC have been tasked by Congress through Dodd-Frank to develop a Memorandum of Understanding to work out the jurisdictional lines
- The MOU remains a work in progress
CFTC Authority Over FTRs

- The Dodd-Frank Act (DFA) requires that any swap must be (i) cleared through a designated clearing organization and (ii) traded on a designated contract market or a swap execution facility if certain conditions are met.
- "Swap" is broadly defined to include most types of OTC derivatives, including energy swaps, emission swaps and commodity swaps.
- A swap arguably covers ARR/FTRs, but DFA Section 722(e) states that FERC jurisdiction is not to be impacted.
- The CFTC has not ruled whether it will exempt ARR/FTRs, or what conditions may apply.
ARRs/FTRs and "End-Users"

- Under the DFA, counterparties that qualify as end users are exempt from the clearing and exchange trading requirements.
- The exemption applies to a counterparty that (i) is not a financial entity, (ii) is hedging its own commercial risk, and (iii) notifies the CFTC how it will meet its financial obligations.
- As noted above, FERC Order 741 does not exempt end-users from the collateral posting requirement for ARR/FTR positions.
Bottom Line

- FERC asserts jurisdiction over financial transactions that are closely related to physical transactions (ARRs/FTRs, for example)
- FERC-CFTC inaction on the MOU and lack of CFTC exemption for ARRs/FTRs raises the risk of dual regulation
- CFTC margin and credit requirements for ARRs/FTRs may differ from those established under FERC tariffs
- Different rules create regulatory uncertainty and potentially increase transaction costs
Contents

- Common issues relevant to energy companies and commodity traders
  - Snapshot of a sample energy company using derivatives – the BIG picture
  - Brief overview of issues raised by energy companies and commodity traders – main topics of concern
  - Points to be addressed in compliance programs and policies and procedures of energy and commodity traders
  - What is on the horizon....
Hedging Strategies For A Refinery

- Swap on crude
- CDS on counterparties
- Forex Spots, forwards, NDFs, swaps, options
- Interest rate swaps
- Tolling agreement on ethanol
- Futures on crude, ethanol, gasoline, nat. gas, S&P 500
- Services Agreement with Optionality
- Trades on RTOs and ISOs in FTRs and ARR
- Options to buy power; full requirements contracts
- Supply agreement priced off of futures
- Forward to buy crude
- Swap on gasoline
Part 1:

- List of Concerns – Based on Comment Letters to the CFTC from Energy Companies and Commodity Traders
Common Issues Relevant to Energy Companies
(based on comment letters)

1. Product Definitions
   - What distinguishes a swap from a forward, a spot, and a services agreement;
   - What is an option (swaps include options now); a non-financial commodity;
   - Trade options on non-financial commodities should not be swaps;
   - FTRs and generation capacity contracts should not be swaps;
   - Renewable energy contracts and emissions should not be swaps.

2. Entity Definitions
   - What entity qualifies as a Swap Dealer and Major Swap Participant;
   - Non-financial entities should qualify as end-users;
   - SD is engaged in "regular" and "ordinary course of business";
   - What is "accommodating demand"?
   - Are inter-affiliate transactions subject to SD registration and business conduct standards?
Common Issues Relevant to Energy Companies
(based on comment letters)

3. End-User Exception to Mandatory Clearing Requirement

- What are the criteria for generally meeting obligations for non-cleared swaps (12 items to disclose);
- The exemption "notice" requirement should be submitted once (currently required every time an end-user intends not to clear a swap);
- Additional requirements for publicly reporting end-users – the board should be able to approve once;
- Must furnish justification to SDs of right not to clear and supporting documentation (significant time and confidentiality issues);
- Severe criminal penalties for abuse of the end-user clearing exemption.
Common Issues Relevant to Energy Companies (based on comment letters)

4. Record-Keeping and Reporting of Swap Transaction Data to SDRs
   - Possible change of terms upon submission of trades to SDRs;
   - DFA does not require that end-users submit daily valuations;
   - Primary economic terms that must be reported include physical transaction that are outside CFTC's jurisdiction;
   - The scope of documentation required to be retained and reported is not clear.

5. Real-Time Reporting of Swap Transaction Data, Inter-Affiliate Transactions
   - Anonymity of traders will not be possible in a highly illiquid market (e.g., nodal market with one generator);
   - Trading ahead will complicate hedging;
   - Real-time reporting obligation should not be imposed on end-users – they simply do not have the resources to carry out these obligations.
Common Issues Relevant to Energy Companies
(based on comment letters)

6. Commodity Options and Agricultural Swaps
   - Options on physical commodities should not be treated as swaps;
   - Part 32.4 (trade option exemption) will be repealed and in conjunction with the repeal of CEA Sec. 2(h)(1), there is uncertainty on how options on physical commodities will be treated;
   - To enter into an option on a physical commodity (e.g., natural gas) parties need to qualify as ECPs;
   - Distinguish options on physical commodities from "swaptions";
   - A clearing house cannot clear physical option (e.g., on power) unless qualified as a utility;
   - Pre-option exercise CFTC jurisdiction, after – FERC's.
     a) E.g., tolling agreement to deliver fuel and market power with a strike or forward capacity agreement with the right to call on energy associated with a plant
Common Issues Relevant to Energy Companies (based on comment letters)

7. Anti-Manipulation and Disruptive Trading Practices
   - There is no duty to disclose (with some new requirements under the DFA, however) – this is different than securities markets where 10b-5 is used as the model;
   - CFTC needs to clarify that new rule prohibits fraud, not requires comprehensive disclosure;
   - Not merely making a reckless statement re swap is sufficient, but also need specific intent to deceive, manipulate, or defraud;
   - Cannot make an "attempted statement" (two provisions re false statements) and (two provisions re fraud) – need to clarify the differences;
   - Need to reconcile the new standard with FERC and FTC.
Common Issues Relevant to Energy Companies (based on comment letters)

8. Swap Trading Relationship Documentation Requirements for SDs and MSPs

- Need to clarify whether ISDA documented trades will suffice and if trades will be binding if executed orally;
- Swaps should not be valued one-by-one but on a portfolio basis;
- SDs should not be the final arbiter of whether a counterparty is an end-user (or a judge of end-user's right not to clear);
- The 5% audit of documentation annually is onerous;
- Orderly liquidation procedures clause is too broad;
- Valuation cannot be agreed in detail in advance (dynamic markets);
- Entities should have the right to delegate valuation responsibilities;
- Confirmations should not be mandated in a specific electronic format and parties should be able to choose their preferred method of confirmation;
- Compression, trade reconciliation (swap valuation disputes one day/five days) are too onerous on end-users.
Common Issues Relevant to Energy Companies (based on comment letters)

9. Duties of SDs and MSPs / Business Conduct Standards
   - "Institutional suitability requirement" should be different for "special entities" and other counterparties;
   - Standards with "special entities" are impractical (SDs cannot be a fiduciary) and cannot opine on advisors (serious issues with the Department of Labor re ERISA);
   - Conflicts of interest – separation of trading, clearing and investment advice functions are impractical for SDs.

10. Chief Compliance Officer (CCO)
    - Scope of duties is overly broad;
    - CCO should not be an executive with powers to fire and hire;
    - Potential criminal liability will make it impossible to find qualified personnel;
    - CCO cannot ensure compliance with all laws and regulations.
11. Position Limits

- Not required to be imposed by the DFA (but significant political pressures on the CFTC to impose);
- Aggregation issues for affiliates;
- Economically equivalent contracts included;
- Few exceptions to position limit requirements;
- CFTC does not have sufficient empirical information to set the limits.

12. Margin and Capital Requirements

- Even though the CFTC has not mandated margin on end-users, SDs and MSPs take a capital hit for not collecting end-user margin – same effect;
- Categories of SD's counterparties are arbitrary (e.g., financial entity with a high risk).
Common Issues Relevant to Energy Companies (based on comment letters)

13. Swap Execution Facilities (SEFs)
- Is a RTO / ISO a trading facility? (see FERC's comments);
- Five RFQ providers alone required or in conjunction with a bulletin board functionality?;
- Is best execution required for central limit order book?;
- How to trade blocks?

- Will FTRs and ARRs be subject to clearing, trading and business conduct standards?
- Possible anti-avoidance issues;
- Abuse of end-user clearing exception – $1 million or imprisonment for not more than 10 years or both.
Common Issues Relevant to Energy Companies (based on comment letters)

15. LEI (legal entity identifiers), USI (uniform swap identifiers), UTIs (uniform transaction identifiers), etc.
   - Who assigns the numbers?
   - Registration requirement with SDRs for the number?
   - What system to use to confirm trades? How will coops be treated?

16. Segregation and Protection of Customer Margin Upon Broker's Bankruptcy
   - Omnibus account may increase risks because the FCM will be as good as its largest customer, thus counterparty due diligence requirements will multiply by the number of customers of an FCM;
   - There should at least be a choice, given physical nature of assets.
Part 2:

- Action points as of 07-16-11 and before 12-31-11
Action Points

- Review your portfolio
  - Identify what contracts your company trades / executes
- Assess how you will be reporting these contracts and whether you need to re-characterize them
  - Review large trader reporting rule; review if you trade forwards, sports, swaps, futures
- Determine through which of your company's affiliates you will be conducting regulated services (e.g., SD)
- Train your employees on new CFTC's anti-manipulation authority and trading practices
- Start preparing compliance policies and procedures
- Train your employees on new business conduct standards
- Start work on your documentation, new forms, new required disclosures
- Prepare a detailed checklist of required actions to be taken when implementation of CFTC rules commences
Part 3:

- What's on the horizon past 12-31-11... and beyond:
Thank You.
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