



# Top Legislative Items for CEA Reauthorization

**May 16, 2013**

# **New Swap Rules Are Having Significant and Often Unintended Impacts on Energy Companies**

## **Primary Areas of Concern**

- **Definition of financial entity needs to be changed**
- **Swap dealer de minimis level should not be permitted to change without affirmative CFTC action**
- **Special entity de minimis level should not apply to transactions with government-related utilities**
- **End-user clearing exception should be available to commercial entities with central desks**
- **Inter-affiliate swaps should not be subject to most regulations**
- **Bona fide hedging under the position limits should not be overly restrictive**
- **Commercial firms should not be subject to margin requirements**

# Overly Broad Regulations and Uncertainty Ultimately Will Increase Commodity Prices for All Consumers

## Key Consequences

- Commercial energy companies are being subjected to regulations designed for banks and investment funds
- Compliance costs are dramatically increasing due to regulatory uncertainty and affirmative obligations
- More difficult to efficiently hedge business risks

**Ultimate Consequence: Increased costs and inefficient hedging result in higher utility bills for all consumers, which directly impacts the national economy**

# Financial Entity Definition Should Be Changed - Central Desks of Commercial Entities Should Not Be Regulated Like Financial Entities

## Financial Entity Definition Needs to be Amended

- **End-users get special treatment not afforded to financial entities in Dodd-Frank and CFTC rules**
  - Including exception from mandatory clearing of swaps and no mandatory margin for uncleared swaps
- **“Financial entity” definition references activity that is “financial in nature” in banking laws**
  - “Financial in nature” means activity banks can do including some physical commodity transactions common in the power industry
- **Cross-reference to banking laws may cause central hedging and marketing affiliates of commercial energy companies to be regulated like financial entities (e.g. hedge funds and banks)**

**Takeaway: amend definition of “financial entity”**

# Swap Dealer De Minimis Level Should Only Change With Affirmative Action by the CFTC

## Swap Dealer De Minimis Should Not Drop by Default

- Swap dealer de minimis amount currently \$8 billion, but automatically reduces to \$3 billion in 2016 unless CFTC takes action
- Reduction is a significant change in market structure that should require a formal rulemaking
- Threat of regulator inaction is potentially very disruptive to market confidence
- Rule is forcing businesses to curb certain activities now because the level may drop
  - Swap dealer definition is overly broad, ambiguous and creates uncertainty for end-users even without de minimis reset

**Takeaway: Require de minimis threshold to be no less than \$8 billion**

# Swap Regulations Should Not Force State and Municipal Utilities to Hedge Financially Only with Banks

## Government-Related Utilities Are Being Forced to Transact Financially Only With Banks

- **Swap dealer de minimis for transactions with special entities is \$25 million**
  - CFTC issued guidance raising level to \$800 million, but imposed onerous conditions (e.g. not available to “financial entities”)
- **Few non-swap dealers will transact financially with government-related utilities (often sophisticated market participants familiar with energy derivatives)**
- **Special entity treatment essentially forces government-related utilities to transact only with large banks that are registered swap dealers or use futures**

**Takeaway: Adopt H.R. 1038**

# End-User Exception from Mandatory Clearing Should be Available to Central Desks That Hedge for Affiliates

## End-User Exception For Affiliates Needs to be Fixed

- Exception to mandatory clearing for non-financial entities hedging business risks
- An entity may use its affiliates' end-user status to claim the exception, but only if is acting as agent for the affiliate
- Common industry practice is for hedging affiliate to transact as a principal, not as agent
- CFTC interprets statutory language strictly so many entities with central hedge desks may not be eligible for the exception

Takeaway: Adopt H.R. 677

# Inter-Affiliate Swaps Should be Excluded From Most Swap Regulations

## Inter-Affiliate Swaps Do Not Pose Significant Risks

- **CFTC rules generally treat inter-affiliate swaps the same other swaps**
  - Subject to reporting and mandatory clearing unless an exception is met
    - CFTC estimated the cost of using the clearing exception for inter-affiliate swaps at almost \$700 million (cost based on reporting requirements)
- **Inter-affiliate swaps have little to no impact on swap markets and do not pose significant risks outside of a corporate family**

Takeaway: Adopt H.R. 677

## **A Restrictive Definition of Bona Fide Hedging in Position Limit Rules Does Not Further Congress' Intent**

### **Bona Fide Hedging Should Recognize Current Legitimate Hedging Practices**

- **CFTC is working on a new position limit rule to replace the vacated rule and has indicated bona fide hedging definition may be even more restrictive**
  - Prior rule required transactions to fit one of eight enumerated categories
- **Legitimate hedging practices are intended to be exempt from speculative position limits**
- **Overly narrow definition of bona fide hedging limits energy companies' ability to hedge and does not further Congressional intent**

**Takeaway: require CFTC to use a principle-based approach that recognizes current hedging practices**

## **End-Users Should Not Be Subject to Mandatory Margin Requirements for Derivatives**

### **End-Users Should Not Be Required to Margin Uncleared Swaps**

- **Banking regulators proposed that swap dealer banks generally must collect margin from all counterparties for uncleared swaps**
  - Very narrow list of acceptable forms of collateral
- **Congress intended that end-users not be subject to margin because end-users do not pose systemic risk and have commercial exposures that often offset derivative positions**

**Takeaway: Adopt H.R. 634**