OTC Energy Derivatives and Financial Reform: A Solution to Financial Stability or a Solution in Search of a Problem?

Harvard Electricity Policy Group, Fifty-Ninth Plenary Session

Panel on “Financial Reform: Intended and Unintended Consequences”

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I. Current Status of Legislation

- House passes Wall Street Reform and Protection Act in December 2009
- Various bills introduced in Senate Committees in 2010—Senate Banking Committee (Dodd) and Senate Agriculture Committee (Lincoln)
- Lincoln bill becomes blueprint for bill on the Senate Floor—Restoring Financial Stability Act of 2010—Title VII is the derivatives part—“Wall Street Transparency and Accountability Act of 2010” (the “Act”)
- Amendments being taken up this week—possible vote this week
II. Review– Existing Regulatory Framework

● 2000 Congress passes the Commodity Futures Modernization Act of 2000 (the “CFMA”) which among other things creates a new statutory classification of a commodity, an “exempt” commodity (essentially energy and metals), which, if traded among “eligible contract participants” would be exempt from most regulation under the Commodities Exchange Act (except certain antifraud and anti-manipulation provisions)

● Concurrent, but Predominant FERC Jurisdiction, Energy Policy Act of 2005– provides FERC with new enforcement tools and enhanced civil penalty authority and gives it authority to issue rules to prevent market manipulation in its regulated markets. FERC begins to interpret its authority as empowering it to exercise enforcement authority in the financial derivatives markets. CFTC and FERC also enter into a Memorandum of Understanding regarding sharing information.

Overview—4 basic mechanisms to regulate derivatives:

1. **Transaction regulation**: is it a swap or security based swap?

2. **Entity regulation**: is the entity a swaps dealer or security based swaps dealer or major swap participant or security based swap participant?

3. **Transparency and Disclosure**: Swaps repositories

4. **Concurrent Regulatory Oversight**: SEC (security based swaps), CFTC (other swaps) and other functional regulators. Role of FERC (?)
1. Transaction Regulation

a. Threshold question: is it a swap?

- Definition in the Act: includes any agreement, contract or swap that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value of 1 or more commodities and that transfers the financial risk associated with a future change in any such value or level without also conveying a future direct or indirect ownership interest in an assets or a transaction commonly known as an “energy swap”

- Exclusions: include: (a) any contract of sale of a commodity for future delivery (or option on a contract); (b) any sale of a nonfinancial commodity or security for deferred payment or delivery, so long as the transaction is intended to be physically settled
1. Transaction Regulation (cont’d)

- Which energy products would fall within this definition?
- Cash settled natural gas, power and oil options and swaps—yes
- Physically settled swaps/options covered by exclusion? Swaps with physical/cash settlement optionality? Book-outs (an agreement between 2 parties to settle their obligations with a cash payment)
- Financial Transmission Rights (“FTRs”) and Capacity Contracts
- FTRs are rights to lock in congestion costs between 2 specific points. Has some attributes of a swap, but is based on physical attributes of the transmission system.
1. Transaction Regulation

b. If it is a swap, is the transaction regulated?

- Clearing requirements: unless an exclusion applies, any person who is a party to a swap shall submit such a swap for clearing to a derivatives clearing organization (“DCO”)

- Exclusions: (a) if no DCO will accept from clearing– required exemption; (b) “Commercial End User Exemption”– not a “financial entity” and as its primary business activity, owns uses, produces, processes, manufactures, distributes, merchandises or markets goods, services or commodities (including coal, natural gas, electricity, crude oil, gasoline, propane, distillates and other hydrocarbons)
  - Cannot be a “major swap participant”
  - Must use the swap to hedge its own commercial risk
1. Transaction Regulation (cont’d)

- What parts of the energy sector can/cannot use this exemption?
  - Must be primary business activity
  - Affiliate of a commercial end user may use the exemption if the affiliate is an agent and is using the exemption to hedge or mitigate the commercial risk of the commercial end user affiliate

- Power marketers included?

- Regional Transmission Organizations (“RTOs”) and Independent System Operators (“ISOs”)?

- Implications of having to clear: higher margin requirements, less liquidity, ability to pledge physical assets and “right way” trades may be restricted
2. Is the entity regulated?

● “Major Swap Participant”:
  – Maintains a “substantial” position in swaps for any major swap categories determined by the SEC or CFTC or
  – Whose outstanding swaps create “substantial” counterparty exposure that could have serious adverse effects on financial stability
    ♦ “Substantial” to be further defined by the CFTC or SEC at a threshold that the regulator determines to be prudent for the effective monitoring, management and oversight of entities that are systematically important or can significantly impact the financial system of the U.S.
    ♦ Excludes positions held for hedging or mitigating commercial risk
2. Is the entity regulated? (cont’d)

- Implications of designation as an Eligible Contract Participant: registration, capital and margin requirements, business conduct and compliance standards
- Regulated as a Derivatives Clearing Organization—ISOs and RTOs? Implications—registration and business conduct standards (risk management, margin requirement, settlement procedures)
3. Transparency and disclosure

a. if required to be cleared, DCO will report;

b. if a dealer or a major swap participant, these entities have reporting requirements;

c. if not required to be cleared or the entity is not a registered dealer or major swap participant, must report to a swap repository (will apply throughout the energy sector)
4. Concurrent, but Predominant CFTC Jurisdiction

- In addition to product and entity regulation, CTC/SEC provided with enforcement authority and authority to set position limits.

- The Act sets out jurisdictional boundaries between banking regulators (“prudential regulators”) and SEC/CFTC. No such express jurisdictional limits are set forth between FERC and SEC/CFTC jurisdiction, but contemplates that the FERC and CFTC would further define their respective jurisdictions in a Memorandum of Understanding.

- Suggestion of a specific exemption that electricity products and services provided under a FERC-approved tariff and subject to regulatory oversight by FERC should be exempt has not been added to current draft. CFTC argues to avoid bright line exemptions which may create loopholes.
IV. Consequences: Intended or Unintended

- Will the next AIG come from the energy sector? Overbroad statutory language can lead to regulatory application to products with no connection to the financial crisis.

- Ambiguous and uncertain application: “intended to be physical settled,” “primary business activity”, “hedging commercial risk”, “substantial”

- Uncertain enforcement: CFTC/SEC or FERC

- Consequences of uncertainty: less liquidity—higher costs passed through to consumers

- Are there trade-offs between stability of financial system and rate regulation and ensuring that electricity rates are just and reasonable? Should there be balancing?
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