Impact of Financial Reform On Energy Companies

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Edison Electric Institute

The Edison Electric Institute (EEI) is the association of all U.S. Shareholder-Owned Electric Companies. Our members provide electricity for 220 million Americans, operate in all 50 states and the District of Columbia, and directly employ more than 500,000 workers.

We also have more than 80 international electric companies as Affiliate Members, and more than 240 industry suppliers and related organizations as Associate Members.

Organized in 1933, EEI works closely with all of its members, representing their interests and advocating equitable policies in legislative and regulatory arenas.

EEI provides public policy leadership, critical industry data, strategic business intelligence, one-of-a-kind conferences and forums, and top-notch products and services

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Why Do Utilities Care

Utilities Use Swaps to Mitigate Risk

- Utilities trade in derivative contracts or swaps to hedge –or lock in –future prices of wholesale power and natural gas and for risk management

- Utilities trade in:
  - Wholesale electricity
  - Wholesale natural gas
  - Coal
  - Refined Products (fuel oil)
  - Emissions (SO_2, NO_X, CO_2)

What are swaps and derivatives

- Derivatives are financial contracts or financial instruments the value of which is derived from the value of an underlying asset.
- Futures, options and <u>swaps</u> are all types of derivatives contracts.
- Two basic categories of derivatives:
  - Exchange traded - futures
  - Privately negotiated – over–the-counter (“OTC”)

Comparison of Exchange and OTC

Exchange Traded

- Price discovery and risk management
- Unknown counterparties
- Standardized products
- Centrally cleared
- No counterparty risk analysis performed
- Contracts secured with cash margin

OTC

- Risk management
- Two known counterparties
- Customized products
- Generally not cleared
- Counterparty risk analysis performed
- Contracts secured by credit agreement, collateral or cash

Overview of Dodd-Frank Act

Commodities Futures Trading Commission

- 1974 – Congress passes the Commodity Futures Trading Commission Act of 1974 which established the CFTC as an independent agency with exclusive jurisdiction to regulate futures trading in all commodities.
- CFTC Mission: Ensure the economic utility and integrity of the commodity futures and options markets
  - Enable markets to provide means for price discovery and offsetting price risk
  - Protect market users and the public
  - Foster open, competitive, and sound markets

Jurisdiction Before Dodd-Frank

- CEA defines "commodities" in terms of agricultural products "and all other goods and articles" (except onions). Jurisdiction over futures and commodity options.
  - Financials excluded
  - Commodity transactions (energy and metals) exempt
- Forwards: Sale of cash commodity for deferred shipment or delivery is not **"Future Delivery"** so exempt
- Shad-Johnson Accord announced by the CFTC and SEC describing each agency's regulatory responsibility over financial derivative instruments
  - CFTC – Commodities: all futures and options
  - SEC – Options on individual securities and certain indexes of securities

Dodd-Frank Act

- Signed into law on July 21, 2010
- Categorized into 16 titles – Title VII
- Purpose of the Act –
  - Promote accountability and transparency
  - Reduce systemic risk
- **Repeals prior regulatory exemptions for OTC derivatives, including energy derivatives, and imposes a regulatory framework upon the OTC derivatives market**
- **All swaps must be cleared or traded through a derivatives clearing organization ("DCO") or swap execution facility ("SEF") unless it meets the end-user exception requirements**
- Creates new players - swap dealers and major swap participants that are subject to extensive oversight and recordkeeping requirements

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Clearing and Reporting

Clearing requirements

- Virtually all swaps need to be cleared by a DCO or SEF - exception swaps that are intended to be physically settled
- Exception – End Users can opt-out of clearing requirement
  - Not a financial entity
  - Using swaps to hedge or mitigate commercial risk
  - Notifies the CFTC how it generally meets its financial obligations

Reporting obligations

- Pre enactment swap transaction information to Swap Data Repository ("SDR")
- Transition Swap
- Real – time reporting of swap transaction data
- SDR reporting (permanent rules)
- End users must still report

Energy End-User Coalition

AGA American Gas Association

APPA American Public Power Association

EEI Edison Electric Institute
Power by Association℠

AXPC American Exploration & Production Council

National Rural Electric Cooperative Association
A Touchstone Energy® Cooperative

American Public Gas Association

AMERICA'S NATURAL GAS ALLIANCE

NGSA Natural Gas Supply Association

epsa Electric Power Supply Association
Advocating the power of competition

AWEA American Wind Energy Association

ipaa America's Oil & Gas Producers

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Regulatory Process

What is a swap – Dodd Frank Act

- Dodd-Frank defines "swap" broadly as any agreement, contract, or transaction that
  - provides on an executory basis for the exchange (on a fixed or contingent basis) one or more payments based on the value or level of one or more commodities, and
  - transfers (in whole or in part) the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset or liability
- Dodd-Frank excludes from the definition of swap any "sale of a nonfinancial commodity or security for deferred shipment or delivery, *so long as the transaction is intended to be physically settled*"

What is a Swap - CFTC

The CFTC has jurisdiction to regulate futures, options and swap transactions. The CFTC's jurisdiction excludes "forward" contracts and spot transactions.

- Key elements of a forward contract:
  - The contract is a commercial merchandizing transaction between commercial market participants;
  - The contract is for the sale of a "non-financial" commodity with an enforceable obligation to make and take delivery;
  - The parties intend to physically settle.
- Options are regulated as swaps. However, commodity options that result in physical delivery when exercised are subject to reduced requirements.

What is a Swap –CFTC

Final Rule provided guidance on:

- Embedded pricing options – 3 part test
- Embedded volumetric options – 7 part test
- Facilities usage agreements (transportation, processing, capacity agreements) – 3 part test plus OGC guidance

Key Concerns with Rulemakings

- End Users erroneously classified as Swap Dealer
- Capital and Margin requirements
- Transaction-by-transaction approach to end-user exception is unnecessarily costly and potentially unworkable
- Proposed definition of swap
- Duplicative and overlapping CFTC/FERC regulation.

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Dodd-Frank Final Rules

- EEI members and the energy coalition have achieved major improvements in many key rulemakings:
  - Recordkeeping and Reporting
  - Trade Option Exemption
  - End-User Exception to Clearing
  - Definition of “Swap Dealer”
  - Definition of “Swap”

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Public Interest Waiver

- Contained in Section 722 (f)(6) of the Dodd-Frank Act and section 4(c)(6) of the Commodity Exchange Act
- Allows CFTC to exempt from requirements of the Dodd-Frank Act FERC and state tariffed products
- RTO/ISO exemption request granted

What's Next?

Dodd-Frank: Work Ahead – Regulatory

- EEI continues to focus on key rules and issues in implementation that remain pending:
  - Margin rules for swap dealers
  - Further guidance on "swap" definition rule
  - Documentation issues (e.g., changes to master agreements)
  - Interpretive Guidance and No action Letters
  - Reporting issues

Implementation Challenges

- Classifying historical transactions and determining who will report
- Classifying future transactions to determine which are swaps or commodity options
- Picking a SDR and meeting its requirements
- Updating/revamping recordkeeping systems to meet CFTC requirements
- Establishing new compliance practices for traders

Conclusion

Changes Due to New Regulations

Voice & Manual Systems

Execution

Electronic Trading

Counterparty A → Counterparty B

Bilateral Risk Management

Clearing

Central Clearing

Counterparty A ← CCP → Counterparty B

Negotiated Margin Agreements

Margin

Required Margin Collection

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Limited Transparency

Reporting

Swap Data Repositories

Implications for the Electric Industry

- New regulator
- Affect contract and counterparty decisions
- Increase in transaction costs
  - New systems
  - Capital and Margin rules
  - SDR costs
  - Cost of clearing

Questions?