

**COMMODITY FUTURES TRADING COMMISSION**

**17 CFR Part 1**

**RIN 3038-AE19**

**Exclusion of Utility Operations-Related Swaps with Utility Special Entities from De Minimis Threshold for Swaps with Special Entities**

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Final rule.

**SUMMARY:** The Commodity Futures Trading Commission (Commission or CFTC) is amending its regulations (Amendments) in order to permit a person to exclude utility operations-related swaps entered into with utility special entities in calculating the aggregate gross notional amount of the person's swap positions, solely for purposes of the de minimis exception applicable to swaps with special entities.

**DATES:** Effective [INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

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**SUPPLEMENTARY INFORMATION:**

**I. Background**

## A. De Minimis Exception from Swap Dealer Definition

Section 1a(49)<sup>1</sup> of the Commodity Exchange Act (CEA or Act) defines the term “swap dealer.” CEA Section 1a(49)(D) requires the Commission to exempt from swap dealer designation an entity that engages in a de minimis quantity of swap dealing, and to promulgate regulations to establish factors for making a determination to so exempt such an entity. Pursuant to this mandate, on April 27, 2012, the Commission adopted Regulation 1.3(ggg), which further defines the term “swap dealer.”<sup>2</sup> Regulation 1.3(ggg) became effective on July 23, 2012, and registration of swap dealers began in December, 2012.<sup>3</sup>

Specifically, the Commission adopted in Regulation 1.3(ggg)(4) an exception from the swap dealer definition for a person that has entered into swap positions connected with its swap dealing activities that, in the aggregate, do not exceed, during the preceding twelve-month period, either of two aggregate gross notional amount thresholds: (i) \$3 billion, subject to a phase in level of \$8 billion<sup>4</sup> (General De Minimis Threshold), and (ii) \$25 million with regard to swaps in which the counterparty is a “special entity” (Special Entity De Minimis Threshold). CEA Section 4s(h)(2)(C) and Regulation 23.401(c) define the term “special entity” to include: a Federal agency; a State, State agency, city, county, municipality, or other political subdivision of a State;

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<sup>1</sup> 7 U.S.C. 1a(49) (2012). The CEA is found at 7 U.S.C. 1 et seq. (2012) and can be accessed through the Commission’s Web site, [www.cftc.gov](http://www.cftc.gov).

<sup>2</sup> See 77 FR 30596 (Swap Dealer Definition Adopting Release).

<sup>3</sup> The further definition of the term “swap” is found in Regulation 1.3(xxx), which became effective October 12, 2012. See 77 FR 48208. See also Regulation 3.10(a)(1)(v)(C), which establishes that each person who comes within the swap dealer definition from and after the effective date of that definition is subject to registration as a swap dealer with the Commission.

<sup>4</sup> The Commission set the General De Minimis Threshold at an initial phase-in level of \$8 billion as of July 23, 2012, the effective date of the Swap Dealer Definition Adopting Release. Upon termination of the phase-in period this amount will decrease to \$3 billion (or such alternative amount as the Commission may adopt by rulemaking) in accordance with the phase-in procedure outlined in Regulation 1.3(ggg)(4)(ii).

any employee benefit plan as defined under the Employee Retirement Income Security Act of 1974 (ERISA); any government plan as defined under ERISA; and any endowment. Regulation 23.401(c) adds to the special entity definition “any instrumentality, department, or a corporation of or established by a State or subdivision of a State.”

#### B. Petition for Rulemaking

On July 12, 2012, the Commission received a petition for rulemaking that sought an amendment of Regulation 1.3(ggg)(4) (Petition).<sup>5</sup> The Petition requested that the Commission amend the regulation to exclude from consideration, in determining whether a person has exceeded the Special Entity De Minimis Threshold, swaps to which the Petitioners and certain other special entities (collectively defined in the Petition as “utility special entities”)<sup>6</sup> are counterparties and that relate to the Petitioners’ and other utility special entities’ utility operations (defined in the Petition as “utility operations-related swaps”).<sup>7</sup>

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<sup>5</sup> Petition for Rulemaking to Amend CFTC Regulation 1.3(ggg)(4), dated July 12, 2012. The Petition was filed by the American Public Power Association, the Large Public Power Council, the American Public Gas Association, the Transmission Access Policy Study Group and the Bonneville Power Administration (Petitioners). The Petition and the comment letters that were submitted in support of it are available at <http://sirt.cftc.gov/sirt/sirt.aspx?Topic=PendingFilingsandActionsAD&Key=23845>.

<sup>6</sup> The Petition defined the term “utility special entity” to mean a government special entity that “owns or operates electric or natural gas facilities or electric or natural gas operations (or anticipated facilities or operations), supplies natural gas and/or electric energy to other utility special entities, has public service obligations (or anticipated public service obligations) under Federal, State or local law or regulation to deliver electric energy and/or natural gas service to utility customers, or is a Federal power marketing agency as defined in Section 3 of the Federal Power Act (16 U.S.C. 796(19)).”

<sup>7</sup> The Petition defined the term “utility operations-related swap” to mean any swap that a utility special entity enters into “to hedge or mitigate commercial risk” (as that phrase is used in CEA Section 2(h)(7)(A)(ii)) “intrinsically related to the electric or natural gas facilities that the utility special entity owns or operates or its electric or natural gas operations (or anticipated facilities or operations), or to the utility special entity’s supply of natural gas and/or electric energy to other utility special entities or to its public service obligations (or anticipated public service obligations) to deliver electric energy or natural gas service to utility customers.”

The Petition defined the term “intrinsically related” to include all transactions related to “(i) the generation or production, purchase or sale, and transmission or transportation of electric energy or natural

The amendment requested by the Petition would have had the effect of allowing a person, in any rolling twelve-month period, to engage in utility operations-related swaps with utility special entities up to an aggregate gross notional amount not to exceed (together with other swaps in which the person was engaged) the General De Minimis Threshold (currently \$8 billion) without being required to register as a swap dealer. In support of this amendment, the Petition claimed that:

The rule amendment is necessary in order to preserve uninterrupted and cost-effective access to the customized, nonfinancial commodity swaps that Petitioners and other Utility Special Entities [as defined in the Petition] use to hedge or mitigate commercial risks arising from their utility facilities, operations and public service obligations.<sup>8</sup>

The Petition further explained that this amendment was needed in order to increase the number of counterparties available to utility special entities to enter into swaps that are necessary for the efficient conduct of the businesses and operations of utility special entities.

### C. CFTC Staff Letter No. 12-18<sup>9</sup>

As the October 12, 2012 effective date for Regulation 1.3(xxx) (defining the term “swap”) approached,<sup>10</sup> Petitioners requested no-action relief from the de minimis

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gas, or the supply of natural gas and/or electric energy to other utility special entities, or delivery of electric energy or natural gas service to utility customers, (ii) all fuel supply for the utility special entity’s electric facilities or operations, (iii) compliance with electric system reliability obligations applicable to the utility special entity, its electric facilities or operations, (iv) compliance with energy, energy efficiency, conservation or renewable energy or environmental statutes, regulations or government orders applicable to the utility special entity, its facilities or operations, or (v) any other electric or natural gas utility operations-related swap to which the utility special entity is a party.”

Finally, the Petition stated that a “utility operations-related swap” did not include “a swap based or derived on, or referencing, commodities in the interest rates, credit, equity or currency asset classes, or a product type or category in the ‘other commodity’ asset class that is based or derived on, or referencing, metals, or agricultural commodities or crude oil or gasoline commodities of any grade not used as fuel for electric generation.”

<sup>8</sup> Petition at 2.

<sup>9</sup> October 12, 2012. This letter can be accessed on the Commission’s Web site at <http://www.cftc.gov/ucm/groups/public/@llettergeneral/documents/letter/12-18.pdf>.

threshold for swaps with certain special entities. In CFTC Staff Letter No. 12-18 (Staff Letter 12-18), the Commission’s Division of Swap Dealer and Intermediary Oversight (Division)<sup>11</sup> concluded that, in light of the representations made in support of the request and in view of the impending effective date for the swap dealer registration requirement, it was appropriate to provide certain registration no-action relief with respect to the Special Entity De Minimis Threshold for persons entering into utility related swaps with utility special entities. Thus, in Staff Letter 12-18 the Division stated that it would not recommend that the Commission commence an enforcement action against a person for failure to apply to be registered as a swap dealer, if:

- (1) the utility commodity swaps connected with the person’s swap dealing activities into which the person – or any other entity controlling, controlled by or under common control with the person – enters over the course of the immediately preceding 12 months (or following October 12, 2012, if that period is less than 12 months) have an aggregate gross notional amount of no more than \$800 million;
- (2) the person is not otherwise within the definition of the term “swap dealer,” as provided in 17 CFR 1.3(ggg) (*i.e.*, the person – or any other entity controlling, controlled by or under common control with the person – has not entered into swaps as a result of its swap dealing activities in excess of the general de minimis threshold or (not counting utility commodity swaps) the special entity de minimis threshold);<sup>12</sup> and
- (3) the person is not a “financial entity,” as defined in section 2(h)(7)(C)(i) of the CEA.

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<sup>10</sup> See 77 FR 48208. Swaps entered into after the effective date of the final rule defining the term “swap” were required to be counted for purposes of determining whether a person’s dealing activity exceeded the Special Entity De Minimis Threshold and the General De Minimis Threshold. See Regulation 1.3(ggg)(4)(i).

<sup>11</sup> The Division is responsible for, among other things, overseeing compliance with the registration requirements applicable to swap dealers.

<sup>12</sup> Division staff emphasized in the letter that the aggregate gross notional amount of a person’s utility commodity swaps would reduce the \$8 billion aggregate gross notional amount under the General De Minimis Threshold for that person.

For purposes of Staff Letter 12-18, Division staff defined the term “utility commodity swap” to mean a swap where: (1) a party to the swap is a utility special entity; (2) a utility special entity is using the swap in the manner described in Regulation 1.3(ggg)(6)(iii);<sup>13</sup> and (3) the swap is related to an exempt commodity in which both parties to the swap transact as part of the normal course of their physical energy businesses. The relief made available by Staff Letter 12-18 was not self-executing. Rather, to take advantage of the no-action relief, a person was required to claim the relief by filing with the Division a notice that, among other things, identified each utility special entity with which the person has entered into utility commodity swaps connected with the person’s swap dealing activities, and that stated with respect to each such utility special entity the total gross notional amount of such utility commodity swaps. Quarterly notice filings were also required.

D. CFTC Staff Letter No. 14-34<sup>14</sup>

Subsequent to the issuance of CFTC Staff Letter 12-18, certain of the Petitioners claimed that specific features of Staff Letter 12-18 (e.g., the requirement to establish that the utility special entity is using the swap to hedge a physical position in an exempt commodity, and the requirement to establish that the counterparty seeking relief is not a “financial entity”) imposed administrative costs or created legal uncertainty such that would-be counterparties were dissuaded from entering into relevant swaps.<sup>15</sup> The

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<sup>13</sup> That is, the utility special entity is using the swap to hedge a physical position, as described in Regulation 1.3(ggg)(6)(iii).

<sup>14</sup> This letter can be accessed on the Commission’s Web site, at <http://www.cftc.gov/ucm/groups/public/@lrlattergeneral/documents/letter/14-34.pdf>.

<sup>15</sup> Letter from Petitioners to Gary Gensler, CFTC Chairman, dated Nov. 19, 2013 (Petitioners’ Letter), available at <http://sirt.cftc.gov/sirt/sirt.aspx?Topic=PendingFilingsandActionsAD&Key=23845>. (One of the original Petitioners did not, however, participate in this follow up letter.)

Petitioners' Letter renewed their request for the relief sought in the previously-filed Petition.

In response to these concerns, on March 21, 2014, the Division issued CFTC Staff Letter No. 14-34 (Staff Letter 14-34), which superseded and broadened the relief provided in Staff Letter 12-18. Specifically, in Staff Letter 14-34 the Division stated that it would not recommend that the Commission commence an enforcement action against a person for failure to apply to be registered as a swap dealer if the person – or any other entity controlling, controlled by, or under common control with the person – does not include “utility operations-related swaps,” as defined in Staff Letter 14-34, in calculating whether it has exceeded the Special Entity De Minimis Threshold, provided that the person's swap dealing activities have not exceeded the General De Minimis Threshold.

## **II. The Proposal**

On June 2, 2014, the Commission published for comment in the Federal Register a proposal to amend Regulation 1.3(ggg)(4) to permit a person to exclude “utility operations-related swaps” (as proposed to be defined) transacted with “utility special entities” (as also proposed to be defined) in calculating the aggregate gross notional amount of the person's swap positions, solely for purposes of the Special Entity De Minimis Threshold (Proposal).<sup>16</sup> Under the Proposal, such utility operations-related swaps would be subject to the higher General De Minimis Threshold applicable to swaps with persons that are not special entities. The Commission is adopting the Proposal subject to certain changes, as noted below.

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<sup>16</sup> 79 FR 31238.

In issuing the Proposal, the Commission recognized that utility special entities have a specialized purpose – i.e., they provide electricity and natural gas production and/or distribution to their customers – and they thus have a unique obligation, in that the commodity services they provide must be continuous, and those services are important to public safety. The Commission also expressed the view that utility operations-related swaps have become an integral part of providing continuous service and managing costs in connection therewith.<sup>17</sup>

Further, the Commission noted that:

[t]he specialized nature of utility special entities distinguishes them from other types of special entities (e.g., public pension plans or municipal governments) in that the conduct of their business routinely involves, and indeed often depends upon access to, specific types of swap transactions that permit them to manage the risks of their businesses and to be able to provide electricity and natural gas consistently. As a consequence, they not only need regular access to swaps that directly affect the smooth operation of their business activities, but also are more likely to have developed expertise with swaps directly related to their operations. While the Special Entity De Minimis Threshold may represent a reasonable protection for other types of special entities that enter into swaps intermittently and whose activities do not depend on a consistent use of particular swaps, for the reasons stated above, the Commission believes that its application to utility operations-related swaps with utility special entities is not as necessary for their regular operation.<sup>18</sup>

The Commission also stated in the Proposal its belief that, because the swaps used by utility special entities are typically conducted in localized and specialized markets and the number of available counterparties may be limited, the \$25 million amount of the existing Special Entity De Minimis Threshold may deter those counterparties from

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<sup>17</sup> 79 FR at 31241.

<sup>18</sup> Id. The Commission did not propose to alter, and is not now altering, the Special Entity De Minimis Threshold with respect to other types of swaps or special entities.

engaging in utility operations-related swaps. Given the obligations of utility special entities to provide continuous service to customers, the Commission concluded that:

the public interest would be better served if the likely counterparties for utility operations-related swaps are able to provide liquidity to this limited segment of the market without registering as swap dealers solely on account of exceeding the Special Entity De Minimis Threshold. In addition, given the expertise utility special entities are likely to have with utility operations-related swaps, the need for a lower de minimis threshold for dealing activity in such swaps with utility special entities is reduced.<sup>19</sup>

Accordingly, the Commission proposed to amend its regulations in order to permit a person to exclude specified swaps (i.e., utility operations-related swaps) entered into with a defined subset of special entities (i.e., utility special entities) when calculating whether the person's swap dealing activities exceed the Special Entity De Minimis Threshold. As stated above, the Commission is adopting the Proposal, subject to certain changes discussed below.

A. Adding an Exclusion for Utility Operations-Related Swaps with Utility Special Entities

Regulation 1.3(ggg) defines the term "swap dealer." The Proposal sought to amend Regulation 1.3(ggg)(4)(i) to permit persons engaging in utility operations-related swaps with utility special entities to exclude such swaps solely for purposes of determining whether they have exceeded the Special Entity De Minimis Threshold. This was to be done by redesignating existing Regulation 1.3(ggg)(4)(i) as Regulation 1.3(ggg)(4)(i)(A), placing the text "In General" before the redesignated regulation and adding a new Regulation 1.3(ggg)(4)(i)(B), captioned "Utility Special Entities."

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<sup>19</sup> Id.

As proposed, Regulation 1.3(ggg)(4)(i)(B)(1) provided that solely for purposes of determining whether a person's swap dealing activity has exceeded the \$25 million aggregate gross notional amount threshold set forth in Regulation 1.3(ggg)(4)(i)(A) for swaps in which the counterparty is a special entity, a person may exclude utility operations-related swaps in which the counterparty is a utility special entity. Proposed Regulation 1.3(ggg)(4)(i)(B)(1) would not, however, have permitted a person to exclude the aggregate gross notional amount of such utility operations-related swaps in determining whether the person had exceeded the General De Minimis Threshold.

Proposed Regulation 1.3(ggg)(4)(i)(B)(4) would have required a person to file a one-time notice with the National Futures Association (NFA) to rely on the exclusion provided by the new rule.<sup>20</sup> The proposed notice provision would have required a representation from the person claiming the exclusion (i.e., the counterparty to the utility special entity) that the person meets the criteria of the exclusion for utility operations-related swaps with utility special entities.

The Commission noted in the Proposal that while Congress adopted additional protections for special entities when engaging in swap transactions, such as the heightened business conduct requirements imposed on swap dealers advising and dealing with special entities,<sup>21</sup> the Proposal would permit persons to engage in a greater aggregate gross notional amount of swaps with utility special entities without registering as a swap dealer. As a result, utility special entities engaging in such swaps with persons not registered as swap dealers would not have the protections provided by the statutory and regulatory provisions applicable to registered swap dealers, both general and specific to

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<sup>20</sup> NFA is a futures association registered as such with the Commission pursuant to CEA Section 17.

<sup>21</sup> See CEA Sections 4s(h)(4) and 4s(h)(5).

dealing activities with special entities. Accordingly, the Commission explained that it proposed the notice filing requirement as a measure to help the Commission monitor compliance with the swap dealer registration requirement, and to better ensure that the exclusion under the Proposal would serve its intended purpose.<sup>22</sup>

However, as explained below, after considering the comments it received on this issue, the Commission has determined not to adopt in Regulation 1.3(ggg)(4)(i)(B) the proposed notice filing requirement.

Additionally, a person relying on the exclusion under the Proposal would have been required to maintain in accordance with Regulation 1.31 books and records that substantiate its eligibility to rely on this exclusion.<sup>23</sup> As explained below, the Commission has adopted in Regulation 1.3(ggg)(4)(i)(B)(4) a provision that requires the person to maintain specifically the written representations, if any, provided to it by utility special entities and upon which it has relied in determining that the utility special entities and the utility operations-related swaps the person engages in meet the criteria of the exclusion in Regulation 1.3(ggg)(4)(i)(B)(1).

## B. New Definitions

### 1. “Utility Special Entity”

Proposed Regulation 1.3(ggg)(4)(i)(B)(2) defined the term “utility special entity” to mean a special entity<sup>24</sup> that owns or operates electric or natural gas facilities, electric or natural gas operations or anticipated electric or natural gas facilities or operations;

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<sup>22</sup> See 79 FR 31238, 31242.

<sup>23</sup> This requirement is consistent with the requirements of other similar Commission regulations, such as the requirement in Regulation 4.7 that commodity pool operators and commodity trading advisors claiming relief under that regulation maintain books and records relating to their eligibility to claim that relief.

<sup>24</sup> As noted above, CEA Section 4s(h)(2)(c) and Regulation 23.401(c) define the term “special entity.”

supplies natural gas or electric energy to other utility special entities; has public service obligations or anticipated public service obligations under Federal, State or local law or regulation to deliver electric energy or natural gas service to utility customers; or is a Federal power marketing agency as defined in Section 3 of the Federal Power Act, 16 U.S.C. 796(19).

## 2. “Utility Operations-Related Swap”

Proposed Regulation 1.3(ggg)(4)(i)(B)(3) defined the term “utility operations-related swap” to mean a swap to which at least one of the parties is a utility special entity that is using the swap to hedge or mitigate commercial risk,<sup>25</sup> and that is related to an exempt commodity.<sup>26</sup> In addition, the swap would have to be an electric energy or natural gas swap, or associated with the operations or compliance obligations of a utility special entity in a manner more fully set forth in proposed Regulation 1.3(ggg)(4)(i)(B)(3)(iv).

The Commission noted in the Proposal that:

in determining whether a person may rely on the proposed exclusion for utility operations-related swaps with utility special entities, it may not always be possible for the person to establish with absolute certainty that a counterparty is a utility special entity, that the counterparty is using a swap to hedge or mitigate commercial risk, that the swap is related to an exempt commodity, or that the swap meets the other requirements to come within the definition of a utility operations-related swap. Therefore, the Commission intends to take the position that a person seeking to rely on the (proposed) exclusion may reasonably rely upon a representation by the utility special entity that it is a utility special entity and that the swap is a utility operations-related swap, as such terms are defined in proposed

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<sup>25</sup> As explained below, in Regulation 1.3(ggg)(4)(i)(B)(3)(ii) as adopted, the Commission revised the language from what was proposed to read “(ii) A utility special entity is using the swap to hedge or mitigate a commercial risk as defined in § 50.50(c) of this chapter” (instead of “in the manner described in §50.50(c)”).

<sup>26</sup> As noted below, the regulation as adopted would permit the swap to be related to an agricultural commodity insofar as such commodity is used for fuel for generation of electricity or is otherwise used in the normal operations of the utility special entity.

Regulation 1.3(ggg)(4)(i)(B), so long as the person was not aware, and should not reasonably have been aware, of facts indicating the contrary.<sup>27</sup>

As noted below, the Commission has adopted this position in Regulation 1.3(ggg)(4)(i)(B)(4).

### III. Comments and Responses

In the Proposal, the Commission sought comments generally regarding the nature and application of the proposed exclusion for utility operations-related swaps with utility special entities for purposes of determining whether a person's swap dealing activities exceed the Special Entity De Minimis Threshold. The Proposal also set forth a non-exclusive list of questions to which the Commission sought responses.<sup>28</sup>

The Commission received ten comment letters in response to the Proposal, from or on behalf of entities identifying themselves as utility special entities, companies engaged in providing physical energy and related activities, industry and trade associations and commercial end users of energy provided by utility special entities.<sup>29</sup>

All of the comment letters were supportive of the proposed amendments to Regulation 1.3(ggg)(4)(i) in general, although some recommended revisions to, or deletion of,

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<sup>27</sup> 79 FR 32138, 31242. This position is consistent with the Commission's approach to permitting reliance on representations for other purposes, such as the requirement in Regulation 50.50(b)(3) that a reporting party have a reasonable basis to believe that its counterparty meets the requirements for the exception to the clearing requirement for end-users. See 77 FR 42560, 42570.

<sup>28</sup> 79 FR 31238, 31242-31423. In the Proposal, the Commission asked for and received comments on the possible benefits of revising its interpretation regarding forward contracts with embedded volumetric optionality. The Commission has decided that this matter is outside the scope of the present rulemaking. Accordingly, the Commission has asked staff to evaluate this issue separately and to consider the comments received in undertaking the evaluation.

<sup>29</sup> Comment letters were submitted by: Arizona Utility Special Entities (AZ Entities Comment Letter) (July 2, 2014); Electrical District No. 3 of Pinal County, Arizona (ED3 Comment Letter) (June 26, 2014); City of Redding, CA (City of Redding Comment Letter) (July 1, 2014); Coalition of Physical Energy Companies (COPE Comment Letter) (July 2, 2014); EDF Trading North America LLC (EDFTNA Comment Letter) (July 2, 2014); Edison Electric Institute (EEI Comment Letter) (July 2, 2014); The Commercial Energy Working Group (Working Group Comment Letter) (July 2, 2014); Electric Power Supply Association (EPSA Comment Letter) (July 2, 2014); the International Energy Credit Association (IECA Comment Letter) (July 2, 2014); and NFP Electric Coalition (NFP Comment Letter) (July 2, 2014).

specific provisions. Several letters provided responses to certain of the specific questions the Commission posed in the Proposal.

Commenters generally agreed that the proposed exclusion was necessary to address the issues facing utility special entities, and that the proposed exclusion would benefit utility special entities and the public interest without compromising the regulatory policy of protecting special entities generally.

Specifically, a number of commenters agreed that utility special entities serve a unique role in the energy commodity markets; namely, utility special entities have an obligation to provide continuous and reliable electric and natural gas service to the public, which is crucial to public safety.<sup>30</sup>

Commenters also stated that utility special entities require access to the swap markets in order to hedge or mitigate their commercial risks, and a lack of available counterparties imposes costs on utility special entities that ultimately are passed on to consumers. Commenters similarly stated that the number of potential counterparties for utility operations-related swaps was generally limited due to the unique nature of the energy markets in which utility special entities operate, and that the Special Entity De Minimis Threshold, and the regulatory burdens associated with it, discouraged this already limited number of potential counterparties from entering into swaps with utility special entities.<sup>31</sup> Many commenters noted further that utility special entities are sophisticated market participants who have expertise in physical and financial energy markets, and that hedging and managing commercial risk is a core competency of utility

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<sup>30</sup> See, e.g., Working Group Comment Letter; ED3 Comment Letter; City of Redding Comment Letter.

<sup>31</sup> See, e.g., AZ Utility Special Entities Comment Letter; NFP Comment Letter; Working Group Comment Letter; ED3 Comment Letter.

special entities.<sup>32</sup> For these reasons, commenters asserted that utility operations-related swaps with utility special entities should be treated differently than other swaps with special entities.<sup>33</sup> In the view of these commenters, utility special entities should be treated the same way as investor-owned utilities with regard to the application of the General De Minimis Threshold.

A. Proposed Regulation 1.3(ggg)(4)(i)(B)(2): “Utility Special Entity”

The Commission received few comments specifically directed to its proposed definition of “utility special entity.” One commenter stated its agreement with the Commission’s definition as proposed.<sup>34</sup> Another asked the Commission to expand the definition of “utility special entity” to include governmental entities, such as school districts, housing authorities, fire departments, water and waste management utilities, involved in large-scale competitive physical procurement of electric energy or natural gas.<sup>35</sup> Like utility special entities, the commenter asserted, these governmental entities have a critical and continuous need for natural gas and electricity, and they face unique, regional market structures wherein the universe of potential counterparties may be further limited to market participants active in a particular geographic region.

The Commission has not, however, so expanded the definition of “utility special entity” in Regulation 1.3(ggg)(4)(i)(B) as adopted. In declining to make this change, the Commission notes that utility special entities are a distinct subset of special entities, for which the Commission believes it is appropriate to relax the safeguards that would otherwise apply with respect to their swap transactions, but solely in the context of utility

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<sup>32</sup> See, e.g., Id.; EEI Comment Letter.

<sup>33</sup> See Id.

<sup>34</sup> See NFP Comment Letter.

<sup>35</sup> See Working Group Comment Letter.

operations-related swaps. As stated in the preamble of the Proposal, utility special entities provide electric or natural gas energy to customers, and this is the primary purpose for, and business of, utility special entities; and they typically have public service obligations to provide uninterrupted service to such customers. In order to meet their obligations and to provide continuous service to customers in a cost-effective manner, utility special entities have an ongoing need to hedge their commercial risks through utility operations-related swaps. Moreover, utility special entities have significant experience and expertise with respect to utility operations-related swaps and the commodities to which those swaps relate. The other types of special entities mentioned by the commenter are more in the nature of end users of electric or natural gas energy. While they may have a limited need to hedge electric and natural gas purchases, doing so is not a fundamental aspect of their general operations (e.g., education, housing, firefighting, etc.); neither their operations nor their obligations are analogous to those of utility special entities; and they are less likely to have the same level of experience with utility operations-related swaps and the commodities underlying those swaps as utility special entities. In balancing the public interest of providing additional regulatory protections for special entities against the public interest that utility special entities be able to effectively manage their commercial risk, the Commission is providing a targeted and tailored exclusion, based on the unique characteristics of utility special entities discussed above. However, the special entities as to which the commenter recommended expanding the Proposal do not have the same characteristics as utility special entities, and do not implicate the same policy considerations. Therefore, an exclusion from the Special Entity De Minimis Threshold for such special entities is not in the public interest

as it is for utility special entities. Accordingly, the Commission has not expanded the definition of “utility special entity” in Regulation 1.3(ggg)(4)(i)(B) as adopted.

B. Proposed Regulation 1.3(ggg)(4)(i)(B)(3): “Utility Operations-Related Swap”

One commenter recommended that the Commission adopt the definition of utility operations-related swap as proposed, stating that the definition encompasses the range of utility supply commodities necessary to provide utility special entities the relief intended by the Proposal.<sup>36</sup>

Another commenter recommended that the Commission should not include the requirement in proposed Regulation 1.3(ggg)(4)(i)(B)(3)(iii) that the swap be related to an “exempt commodity” in order to be a utility operations-related swap. This requirement, in the view of the commenter, would add ambiguity to the definition because the Commission’s regulations and interpretations implementing its jurisdiction over swaps do not consistently use the pre-Dodd-Frank Act<sup>37</sup> categorizations of “exempt commodity,” “agricultural commodity” and “excluded commodity” to classify swaps.<sup>38</sup> The commenter expressed the view that the Dodd-Frank Act and the Commission’s regulations regarding the definition of “swap” do not use the term “exempt commodity” but instead distinguish swaps involving “nonfinancial commodities” from four asset classes of financial commodity swaps (involving rates, credit, currencies and equities); therefore, the definition of utility operations-related swap should also follow that approach. Alternatively, the commenter recommended that if the Commission retained in the definition, as adopted, the proposed requirement that the swap be related to an exempt

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<sup>36</sup> See City of Redding Comment Letter.

<sup>37</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>38</sup> See NFP Comment Letter.

commodity, then the Commission: (1) should clarify that all “nonfinancial commodities” (other than agricultural commodities) are exempt commodities; and (2) should expand the proposed definition of utility operations-related swap to include swaps related to agricultural commodities, as, the commenter claimed, there are agricultural commodities that are used for fuel for electric generation, or that may otherwise be “associated with utility operations.”

Several other commenters similarly recommended that the Commission conform the proposed definition of utility operations-related swap to the definition of the term “Exempt Non-Financial Energy Transaction” contained in the Commission’s Order Exempting, Pursuant to Authority of the Commodity Exchange Act, Certain Transactions Between Entities Described in the Federal Power Act, and Other Electric Cooperatives, (April 2nd Order).<sup>39</sup> In the view of these commenters, conforming the definition with the April 2nd Order would provide greater clarity to market participants and would allow for a more seamless implementation of the exclusion in proposed Regulation

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<sup>39</sup> 78 FR 19670. See EPSA, IECA and NFP Comment Letters. The April 2<sup>nd</sup> Order provides that the term “Exempt Non-Financial Energy Transaction” means “any agreement, contract, or transaction based upon a ‘commodity,’ as such term is defined in CEA section 1a(9) and Commission regulation 1.3(e), that would not have been entered into, but for an Exempt Entity’s need to manage supply and/or price risks arising from its existing or anticipated public service obligations to physically generate, transmit, and/or deliver electric energy service to customers. The term ‘Exempt Non-Financial Energy Transaction’ excludes agreements, contracts, and transactions based upon, derived from, or referencing any interest rate, credit, equity or currency asset class, or any grade of a metal, or any agricultural product, or any grade of crude oil or gasoline that is not used as fuel for electric energy generation. The term ‘Exempt Non-Financial Energy Transaction’ also excludes agreements, contracts, or transactions entered into on or subject to the rules of a registered entity, submitted for clearing to a derivatives clearing organization, and/or reported to a swap data repository.” *Id.* at 19688.

The April 2nd Order limits Exempt Non-Financial Energy Transactions to specifically defined categories of transactions, which the April 2nd Order provides may exist as stand-alone agreements or as components of larger agreements that combine these categories. The April 2nd Order identifies these categories of transactions as follows: (1) electric energy delivered; (2) generation capacity; (3) transmission services; (4) fuel delivered; (5) cross-commodity pricing; and (6) other goods and services. *Id.*

1.3(ggg)(4)(i)(B), since market participants are already familiar with the “Exempt Non-Financial Energy Transaction” definition in the April 2nd Order.

The Commission is addressing these comments in two parts: (1) whether the Commission should adopt as proposed a utility operations-related swap definition requiring that the swap be “related to an exempt commodity, as that term is defined in Section 1a(20) of the Act,” or the Commission should adopt in the definition another type of limiting criteria, as identified by the commenters; and (2) whether the Commission should adopt a definition of utility operations-related swap that includes certain “agricultural commodities” as that term is defined in Regulation 1.3(zz).

After considering the commenters’ arguments, the Commission has determined to adopt in Regulation 1.3(ggg)(4)(i)(B)(3) the proposed requirement that a utility operations-related swap must relate to an exempt commodity.<sup>40</sup> The Proposal responded to the request in the Petition to provide relief for counterparties to certain types of swaps used by utility special entities to hedge their day-to-day operational activities. The Proposal noted that: utility special entities have a greater need for these swaps than for other types of swaps and that need is ongoing; the underlying commodities identified in such swaps and the counterparties for such swaps are often regional (e.g., the location for delivery of the commodity and the location of the operations of the counterparties); these swaps relate to underlying commodities which utility special entities regularly use as part of their normal operations; and with respect to such swaps, utility special entities generally have a level of expertise and sophistication. Given these factors, the Proposal allowed for a limited reduction in the protections that the Special Entity De Minimis

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<sup>40</sup> The requirement that a swap must relate to an exempt commodity was included in Staff Letter 12-18.

Threshold would provide for utility special entities, in order to increase the number of counterparties available for utility special entities that need to use these types of swaps.

However, as stated in the preamble to the Proposal, the Commission recognizes that the Special Entity De Minimis Threshold is generally appropriate in light of the special protections that Title VII of the Dodd-Frank Act provides to special entities.<sup>41</sup> In keeping with the statutory and regulatory objective of providing additional protections for special entities generally, the Commission believes that the definition of utility operations-related swap in Regulation 1.3(ggg)(4)(i)(B)(3) should be written to exclude swaps that are not related to commodities used by utility special entities in the ordinary course of their daily operations. In this way, utility special entities would be treated in the same way as other special entities with regard to swaps that do not implicate the policies underlying the proposed exclusion.

The commenters' recommendation that the definition of utility operations-related swaps conform to the definition of the term "Exempt Non-Financial Energy Transaction" contained in the April 2nd Order is misplaced, because the April 2nd Order addresses transactions between a limited set of counterparties and was based on different underlying policy considerations. In accordance with CEA Section 4(c)(6),<sup>42</sup> the April 2nd Order broadly exempts from most requirements of the CEA and Commission regulations all "Exempt Non-Financial Energy Transactions" entered into solely between

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<sup>41</sup> See 79 FR at 31245.

<sup>42</sup> As discussed by the Commission in the preamble to the April 2nd Order, CEA Section 4(c)(6) "builds upon the Commission's existing 4(c) exemptive authority by providing that the Commission 'shall . . . exempt from the requirements of th[e] Act an agreement, contract, or transaction that is entered into \* \* \* between entities described in section 201(f) of the Federal Power Act (16 U.S.C. 824(f)),' but only '[i]f the Commission determines that the exemption would be consistent with the public interest and the purposes of [the Act].'" 78 FR at 19671.

Exempt Entities.<sup>43</sup> The scope of the transactions covered by the exemption was defined in the context of both this unique “closed loop” market (i.e., transactions where both parties are Exempt Entities) and also the underlying policies for the exemption. More specifically, the Commission determined that such transactions between not-for-profit utilities (in a closed loop) will not materially impair price discovery or the functioning of markets regulated by the Commission.<sup>44</sup> The Commission also determined that the not-for-profit structure and governance model of all Exempt Entities reduce the incentives and other conditions that traditionally lead to fraudulent or manipulative trading activity, and should therefore mitigate the need for prescriptive federal oversight.<sup>45</sup> Thus, the transactions and circumstances addressed by the April 2nd Order – and the underlying statutory and regulatory policy considerations – are not analogous to those addressed and implicated by the Proposal.<sup>46</sup>

Similarly, the commenters’ recommendation that the Commission base the definition of utility operations-related swap on the distinction between nonfinancial commodities and commodities related to the four financial asset classes would allow for

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<sup>43</sup> The term “Exempt Entity” is defined in the April 2nd Order as “(i) any electric facility or utility that is wholly owned by a government entity, as described in Federal Power Act (‘FPA’) section 201(f), 16 U.S.C. 824(f); (ii) any electric facility or utility that is wholly owned by an Indian tribe recognized by the U.S. government pursuant to section 104 of the Act of November 2, 1994, 25 U.S.C. 479a-1; (iii) any electric facility or utility that is wholly owned by a cooperative, regardless of such cooperative’s status pursuant to FPA section 201(f), so long as the cooperative is treated as such under Internal Revenue Code section 501(c)(12) or 1381(a)(2)(C), 26 U.S.C. 501(c)(12), 1381(a)(2)(C), and exists for the primary purpose of providing electric energy service to its member/owner customers at cost; or (iv) any other entity that is wholly owned, directly or indirectly, by any one or more of the foregoing. The term ‘Exempt Entity’ does not include any ‘financial entity,’ as defined in CEA section 2(h)(7)(C).” 78 FR at 19688.

<sup>44</sup> Id. at 19679.

<sup>45</sup> Id. This rationale is not applicable to transactions between a utility special entity and a counterparty that is not a utility special entity.

<sup>46</sup> The NFP Comment Letter asserts that “Members of [NFP] (including utility special entities) are ‘Exempt Entities’ as such term is defined in the [April 2nd Order].” Even assuming this would be the case with respect to all utility special entities, not just NFP members, the April 2nd Order is limited to transactions “solely between Exempt Entities,” whereas the exclusion in Regulation 1.3(ggg)(4)(i)(B) will apply to swaps where only one party is a utility special entity.

swaps related to commodities that are not regularly used by utility special entities to be included in the definition of utility operations-related swap.<sup>47</sup> While the Commission believes that all of the types of swaps that fall within the four financial asset classes noted should be excluded from the defined term, there are many other swaps – both financial and non-financial – that also should not be included in the definition given the rationale for providing the exclusion for utility special entities in a way that is balanced with the need to maintain appropriate protections for special entities generally.

This can be illustrated by considering the definition in the April 2nd Order to which the commenters referred. The definition of the term “Exempt Non-Financial Energy Transaction” in the April 2nd Order excludes transactions “referencing any interest rate, credit, equity or currency asset class or any grade of a metal, or any agricultural product, or any grade of crude oil or gasoline that is not used as fuel for electric energy generation.” As such, the April 2nd Order carves out from the relief it provided both swaps in the four delineated financial asset classes and swaps related to certain physical commodities, to the extent those commodities are not used by the utility special entities for electric energy generation.

However, the April 2nd Order criteria may create gaps and uncertainty in the definition of utility operations-related swaps that could both result in ambiguity for market participants and overly reduce the general protections intended for special entities, including utility special entities. The April 2nd Order does not define the terms “interest

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<sup>47</sup> The Commission employed the term “nonfinancial commodity” in the preamble of the Federal Register release adopting the definition of the term “swap” to discuss a category of transactions for which the forward exclusion would apply. See 77 FR 48208, 48227 *et seq.*, n.205. As such, that term serves a purpose in the swap definition regulation that is functionally different from the utility operations-related swap definition that the Commission is adopting in this Federal Register release.

rate asset class,” “credit asset class,” “equity asset class” or “currency asset class.”

Although the meaning of these terms may be generally understood, the lack of a definition creates a degree of ambiguity. For example, it is generally understood that the exclusion provided in the final regulation should not include interest rate swaps that special entities might use to hedge interest rate risk related to their bonds. However, such a hedge could be accomplished indirectly by entering into a bond price swap either on their bonds or less directly, on a bond price index. As another example, it is also unclear whether the definition in the April 2nd Order would exclude a total return swap on a utility special entity’s bonds (or any other bonds for that matter). Although special entities should not be barred from entering into such swaps, in the absence of an exclusion for such swaps, the low Special Entity De Minimis Threshold would require that a person dealing in such swaps with a special entity (in excess of the \$25 million amount) be registered as a swap dealer, irrespective of whether the special entity is a utility special entity. This is consistent with the statutory intent to provide greater protections for special entities generally. In this way, the protections provided for special entities by the swap dealer regulations would apply to swaps of this nature to which any kind of special entity is a party, including utility special entities.

Finally, while the criteria in the April 2nd Order except out certain specified physical commodities as described above, those exceptions are fairly specific and would not except out a swap referencing any other physical commodity to the extent the swap might be shown to “manage supply and/or price risks arising from [an entity’s] existing or anticipated public service obligations.” That approach provides a significant amount of flexibility in determining which swaps fit within the definition. For some purposes,

this flexibility can be helpful in that determining when a swap is being used to “manage,” or “hedge or mitigate” (the term in Regulation 1.3(ggg)(4)(i)(B)(3)(ii) as adopted that serves a similar function) risk can be highly fact specific and to a degree subjective. This flexibility, while beneficial in some contexts, can create a degree of ambiguity because it allows for different interpretations based on the facts and circumstances. This ambiguity may have been acceptable in the context of the April 2nd Order because it addressed only swaps between “Exempt Entities” (e.g., not involving commercial dealers or financial entities) and because the April 2nd Order involves different public policy considerations, as described above. On the other hand, this ambiguity could result in overly-weakened protections for special entities if incorporated into the Amendments.

Maintaining in Regulation 1.3(ggg)(4)(i)(B)(3)(iii) the requirement that utility operations-related swaps must relate to exempt commodities mitigates this ambiguity and helps maintain the protections intended for special entities by the Dodd-Frank Act and the Commission’s regulations. The term “exempt commodity” is defined as a commodity that is not an “excluded commodity” or an “agricultural commodity.” Briefly stated, excluded commodities (agricultural commodities are addressed below) encompass swaps referencing the four financial classes identified in the April 2nd Order and swaps related to: debt instruments; indexes or measures of inflation or other macroeconomic indexes or measures; commodities based on rates, differentials, indexes or measures of economic or commercial risk, return or value that are not based in substantial part on the value of a narrow group of commodities or are based solely on one or more commodities that have no cash market; or commodities based on any occurrence or contingency that is out of the

control of the parties and associated with an economic consequence.<sup>48</sup> Accordingly, maintaining in Regulation 1.3(ggg)(4)(i)(B)(3)(iii) as adopted the proposed requirement that the swap relate to an “exempt commodity” would limit the final regulation to types of swaps that a utility special entity may need to operate effectively while at the same time excluding swaps that relate to many types of commodities that are not generally used in special utility entity operations.

Notwithstanding the foregoing, the term “excluded commodity” has a degree of complexity. Accordingly, by this Federal Register release, the Commission is taking the position that the requirement in Regulation 1.3(ggg)(4)(i)(B)(3)(iii) that the swap “relate to an exempt commodity” includes swaps that reference any physical commodity involved in a utility special entity’s normal operations. For example, the requirement in Regulation 1.3(ggg)(4)(i)(B)(3)(iii) as adopted would include a swap based on: the price of a grade of oil or coal that the utility special entity purchases to fuel its power generation facilities; a narrow index of grades of oil or coal that includes that grade of oil or coal; electricity generated or distributed by a utility special entity or potentially needed for peak power; or water needed to power hydroelectric generating facilities of the entity.<sup>49</sup> On the other hand, a swap based on a broad commodity index, a bond price, inflation indexes or weather occurrences would not meet the requirement in Regulation 1.3(ggg)(4)(i)(B)(3)(iii).

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<sup>48</sup> See 7 U.S.C. 1a(19).

<sup>49</sup> The foregoing list of examples is not intended to be an exhaustive list of commodities on which a swap must be based such that the swap would come within the definition of the term “utility operations-related swap.” Rather, it is being provided to illustrate how to apply the definition in the context of utility special entity operations.

Regarding the commenter's request to include in the final utility operations-related swap definition agricultural commodities used for certain utility purposes,<sup>50</sup> the Commission acknowledges that it is possible that a utility special entity may use agricultural commodities, such as ethanol or wood chips, in its normal operations and therefore the definition could be expanded for this purpose. The Commission is concerned, however, that including agricultural commodities generally in the definition may broaden the definition too much because generally, agricultural commodities are not used in energy utility operations. Accordingly, the Commission is adopting in Regulation 1.3(ggg)(4)(i)(B)(3)(iii) a definition of utility operations-related swap that includes swaps relating to agricultural commodities that are used for fuel for electric generation or are otherwise used in the normal operations of the utility special entity.

One commenter recommended that the Commission adopt in lieu of the proposed term and definition of "utility operations-related swap" a term and definition of "utility operations-related transaction," which would include all non-financial commodity transactions for deferred shipment or delivery where the parties intend physical settlement at the time the transaction was executed (including stand-alone or embedded options or optionalities), claiming this was necessary to provide utility special entities with the relief they required.<sup>51</sup> Alternatively, the commenter asked that prior to, or concurrently with, the issuance of a regulation adopting the "utility operations-related swap" definition, the Commission act on the commenter's request for reconsideration of the Commission's interpretation of CEA Section 1a(47) that all commodity options are swaps, and clarify the scope of the Commission's jurisdiction over nonfinancial

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<sup>50</sup> See NFP Comment Letter.

<sup>51</sup> Id.

commodity swaps.<sup>52</sup> Further, the commenter urged the Commission to provide guidance that all transactions used by a utility special entity to hedge or mitigate commercial risks, and that have the benefit of Commission exclusion by interpretation or an order exempting them from the Commission's jurisdiction over swaps, are also excluded from the Special Entity De Minimis Threshold.

The Commission is declining to adopt any of these recommendations. An entity may be a swap dealer (and be subject to regulation as such) if that entity is dealing in "swaps," as defined in the CEA and the Commission's regulations. Whether any particular transaction of the types identified by the commenter is or is not a swap may be fact-dependent. Accordingly, the broad statements requested from the Commission by the comment could effectively amount to an interpretation or modification of the definition of the term "swap." The Commission did not also propose to modify or interpret the definition of the term "swap" when it issued the Proposal. Rather, in proposing Regulation 1.3(ggg)(4)(i)(B)(3), the Commission intended to define a subset of swaps as utility operations-related swaps. Thus, the commenter effectively has asked the Commission to go beyond the scope of the Proposal and to interpret or modify the definition of the term "swap" in order to provide relief that is broader than what the Proposal contemplated. The Commission notes, however, that under the definition of swap dealer in Regulation 1.3(ggg), any transactions identified in the comment that are not "swaps," as defined in the CEA and the Commission's regulations, are not counted

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<sup>52</sup> In its October 12, 2012, comment letter on the Commission's proposed regulations to further define the terms "swap" and "swap dealer," NFP had asked the Commission to reconsider its conclusion that "commodity options are swaps under the statutory swap definition." See 77 FR 48208, 48236 (Aug. 13, 2012). NFP's letter may be accessed at: <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59235&SearchText=>.

for purposes of the Special Entity De Minimis Threshold or the General De Minimis Threshold.

Another commenter<sup>53</sup> recommended that in lieu of the proposed text of Regulation 1.3(ggg)(4)(i)(B)(3)(ii) the Commission should adopt the following text: “(ii) A utility special entity is using the swap to hedge or mitigate commercial risk as defined in §50.50(c) of this chapter.”<sup>54</sup> Otherwise, the commenter claimed, the requirement could be misinterpreted to mean that a utility operations-related swap must be used to invoke an exception to the mandatory clearing requirement in order to qualify for the proposed exclusion.

The Commission finds that this recommendation is consistent with the intent of the Proposal and that it would provide greater clarity. Accordingly, the Commission is adopting in Regulation 1.3(ggg)(4)(i)(B)(3)(ii) the recommended text quoted above.

The same commenter also recommended that the Commission confirm that proposed Regulation 1.3(ggg)(4)(i)(B) would apply to a swap that unwinds an existing hedge. The commenter expressed the view that market participants often hedge dynamically to optimize the value of underlying physical assets or portfolios, and may modify hedging structures related to a physical asset or position when the relevant pricing relationships applicable to the asset change. Dynamic hedging, according to the commenter, may involve leaving an asset or position unhedged when necessary to mitigate lost opportunity cost risk, which may require hedges to be established, unwound, and re-established on an iterative basis over time. The commenter noted that in the

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<sup>53</sup> See Working Group Comment Letter.

<sup>54</sup> The proposed text read: “(ii) A utility special entity is using the swap in the manner described in § 50.50(c) of this chapter.”

preamble of the Federal Register release announcing the adoption of Regulation 50.50(c), the Commission stated that “qualification as bona fide hedging does not require hedges, once entered into, to remain static. The Commission recognizes that entities may update their hedges periodically when pricing relationships or market factors applicable to the hedges change.”<sup>55</sup> In light of this statement, the Commission agrees with the recommendation. Accordingly, the Commission confirms that the language quoted above concerning bona fide hedging is equally applicable to transactions qualifying under Regulation 1.3(ggg)(4)(i)(B).

### C. Comments Addressing Both Definitions

A commenter<sup>56</sup> urged the Commission to ensure that the definitions of “utility special entity” and “utility operations-related swap” follow as closely as possible the analogous provisions of Staff Letter 14-34 (which provides relief for utility special entities pending a final rulemaking by the Commission), in order to minimize the burden on counterparties in transitioning from reliance on that no-action letter to reliance on the new regulation. In this regard, the commenter asked the Commission to determine whether the benefits associated with any proposed deviation from the terms of Staff Letter 14-34 outweigh the costs and burdens of the deviation to market participants.

In response, the Commission notes that the text of the analogous provisions in Staff Letter 14-34 is similar, but less specific (e.g., it does not require that the swap be related to an exempt commodity), and therefore the wording of the letter is subject to greater interpretive flexibility that could lead to unintended consequences. Staff Letter 14-34 was intended to provide short-term relief until regulatory changes could be

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<sup>55</sup> 77 FR 42560, 42575 n.69.

<sup>56</sup> See EDFTNA Comment Letter.

implemented, whereas the final regulation will be a more permanent solution. While the Commission is sympathetic to the concerns expressed by the commenter regarding continuity, it is more important to define these terms precisely to effect the regulatory and policy purposes of the regulation.

Accordingly, from and after the effective date of the Amendments, the relief made available by Staff Letter 14-34 will terminate, except with respect to swaps entered into in reliance upon Staff Letter 14-34 prior to such effective date. In recognition of the fact that some persons may have entered into swaps in reliance on Staff Letter 14-34, the Commission is clarifying that such persons may continue to rely upon the relief provided in Staff Letter 14-34 with respect to swaps entered into prior to the effective date of the Amendments.<sup>57</sup>

Five commenters<sup>58</sup> asked that the Commission include in the text of the final rule (and not just in the preamble text of the adopting release) a provision that a person seeking to rely on the exclusion from the \$25 million Special Entity De Minimis Threshold be able to rely on representations from the utility special entity for the basis of the exclusion, provided the reliance is made in good faith. One of the five commenters<sup>59</sup> also suggested the representations be in writing and another of these commenters<sup>60</sup> suggested text for the purpose.

The Commission believes that explicitly stating in Regulation 1.3(ggg)(4)(i)(B) that a person may rely upon a written representation from a utility special entity will

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<sup>57</sup> Such swaps would, however, need to be counted for purposes of the General De Minimis Threshold, as provided in Staff Letter 14-34.

<sup>58</sup> See EEI, COPE, EDFTNA, IECA and NFP Comment Letters.

<sup>59</sup> See COPE Comment Letter.

<sup>60</sup> See NFP Comment Letter.

ensure that prospective counterparties are aware that such reliance is permitted under the regulation, and the Commission is doing so in Regulation 1.3(ggg)(4)(i)(B)(4).

D. Proposed Regulation 1.3(ggg)(4)(i)(B)(4): Notice Filing Requirement

In the Proposal, the Commission solicited comment on the proposed notice requirement provision, specifically asking whether it would enable the Commission to achieve the objectives of the notice provision, as stated in the Proposal. One commenter supported the notice provision, stating that the requirement will provide the Commission with visibility to monitor the entities utilizing the exclusion.<sup>61</sup> Another commenter voiced support for the purposes of the notice provision, stating that the Commission should be able to identify the entities that elect to rely on the exclusion in order to ensure that the exclusion serves the intended purpose of enabling utility special entities to manage operational risks in a cost-effective manner while simultaneously monitoring compliance with the swap dealer registration requirements.<sup>62</sup>

Six commenters<sup>63</sup> stated that the Commission should not adopt the proposed notice provision because it would impose unnecessary regulatory risks and burdens in that the proposed attestation requirement would create personal liability regarding factual issues that are in the control of the utility special entity, not the person making the attestation, and because the criteria would relate to swaps to be executed in the future. The commenters predicted that these risks and burdens would discourage persons from serving as counterparties to utility special entities, which would be contrary to the

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<sup>61</sup> See City of Redding Comment Letter.

<sup>62</sup> See EDFTNA Comment Letter. The commenter did not agree, however, that the Commission's objective of identifying relying entities would be served by requiring such entities to file a notice with NFA.

<sup>63</sup> See EPSA, EDFTNA, Working Group, IECA, NFP and EEI Comment Letters.

purpose of the Proposal. They also pointed out that counterparties relying on any other de minimis exclusion are not subject to a notice requirement and asserted that the Commission had not provided any justification for treating persons who serve as counterparties to utility special entities any differently.

Three of the six commenters<sup>64</sup> disputed the rationale for the proposed notice provision set forth in the Proposal (that Congress has determined that special entities need additional protection and the notice filing will help the Commission monitor these transactions), stating that the Commission acknowledged in the Proposal that utility special entities are sophisticated and experienced market participants, and contending that utility operations-related swaps will be reported to swap data repositories (“SDRs”) and, as such, the Commission can already see which entities are entering into swap transactions with utility special entities.

After considering the comments it received on this issue, the Commission has determined not to retain the notice filing requirement in the final regulation.<sup>65</sup> However, the Commission believes that it is important that it obtain information regarding whether counterparties to utility special entities are relying on the exclusion in Regulation 1.3(ggg)(4)(i)(B) and therefore do not need to register as swap dealers and generally how the exclusion is affecting the markets for utility operations-related swaps. Accordingly, the Commission has directed its staff to assess possible amendments to the Commission’s regulations that would provide the Commission with such information, including, potentially, amendments to Part 45 of the Commission’s regulations to add a data

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<sup>64</sup> See EEI, Working Group and NFP Comment Letters.

<sup>65</sup> Accordingly proposed Regulation 1.3(ggg)(4)(i)(B)(5) (which set forth the requirement to keep certain records) is renumbered as Regulation 1.3(ggg)(4)(i)(B)(4) in the final regulation.

reporting field identifying utility operations-related swaps when they are reported to SDRs.

E. Proposed Regulation 1.3(ggg)(4)(i)(B)(5): Books and Records Requirement

Seven commenters stated that the Commission should not adopt any recordkeeping requirement in the final regulation, claiming that such a requirement would be unnecessary and redundant.<sup>66</sup> Counterparties to swaps are already required to maintain appropriate records for purposes of demonstrating compliance with the General De Minimis Threshold. As such, the commenters said, the Commission has access to this information and additional recordkeeping requirements for utility operations-related swap transactions are not needed.

Two of the seven commenters<sup>67</sup> went on to recommend that if the Commission were to specify any additional books and records to be kept, it should not repeat the deliberate vagueness of Regulation 45.2. One commenter<sup>68</sup> suggested that the Commission should specify that a record of a counterparty's representation that it is eligible for the exclusion should be sufficient, because, it asserted, a counterparty relying on such a representation may not necessarily have any other records demonstrating that the exclusion applies.

The Commission believes that, while the general recordkeeping requirement in the Proposal would provide greater oversight capabilities, it could be burdensome relative to the benefits it would provide. As commenters noted, Part 45 of the Commission's regulations imposes general recordkeeping requirements upon persons that are

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<sup>66</sup> See EEI, EPSA, NFP, COPE, Working Group, IECA, and EDFTNA Comment Letters.

<sup>67</sup> See COPE and Working Group Comment Letters.

<sup>68</sup> See COPE Comment Letter.

counterparties to swaps, whether or not such persons are within the swap dealer definition and therefore subject to the requirement to register as such,<sup>69</sup> and the Commission agrees that such records would include those necessary to demonstrate the person's compliance with the General De Minimis Threshold. Accordingly, a record of each utility special entity's representation that it is a utility special entity and that the swap is a utility operations-related swap, together with the general recordkeeping requirements under Part 45, should provide the Commission with sufficient information for compliance purposes.

Therefore, the Commission is including in the regulation as adopted the change suggested by one of the commenters<sup>70</sup> by requiring in Regulation 1.3(ggg)(4)(i)(B)(4) as adopted only that each person who relies on the written representation of a utility special entity retain such representation among its required records, in accordance with Regulation 1.31. Including this requirement in the final regulation makes clear that records of such written representations, if received, are a necessary element of the records required to be kept pursuant to the general requirements of Part 45.

#### F. Comments Addressing Specific Questions Asked by the Commission

##### 1. Question 8 – Appropriateness of the De Minimis Threshold

The Commission asked whether the \$8 billion General De Minimis Threshold was appropriate in the context of utility operations-related swaps or whether a higher or lower threshold should be adopted.

Two commenters offered support for the Commission's application of the General De Minimis Threshold to utility operations-related swaps, stating that applying that

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<sup>69</sup> See, e.g., Regulation 45.2(b) ("All non-SD/MSP counterparties subject to the jurisdiction of the Commission shall keep full, complete, and systematic records, together with all pertinent data and memoranda, with respect to each swap in which they are a counterparty . . . .")

<sup>70</sup> See COPE Comment Letter.

threshold strikes the appropriate regulatory policy balance,<sup>71</sup> and that it would level the playing field between utility special entities and investor-owned utilities.<sup>72</sup>

Five commenters encouraged the Commission to revisit the General De Minimis Threshold and to eliminate any automatic reset to any lower threshold.<sup>73</sup> These commenters also stated that the Commission should not adopt a separate threshold for utility operations-related swaps with utility special entities that was lower than the General De Minimis Threshold, as it would create confusion and serve to limit the number of counterparties willing to transact with utility special entities.

The second comment (eliminating an automatic reset of the General De Minimis Threshold) is beyond the scope of the Proposal and this rulemaking. With regard to the third comment, the Commission did not propose and is not adopting a separate threshold below the General De Minimis Threshold, and accordingly no changes to the Proposal are called for by these comments.

## 2. Question 9 – Appropriateness of Limiting Counterparty Eligibility

Question 9 in the Proposal asked whether the nature of the person entering into swaps with a utility special entity should be a factor in determining whether the person can rely on the exclusion (e.g., by limiting the exclusion to persons who are not “financial entities,” as provided in Staff Letter 12–18). Two commenters<sup>74</sup> asserted that the Commission should not impose limitations on the types of counterparties eligible to rely on Regulation 1.3(ggg)(4)(i)(B), arguing that such limitations would likely restrict the number of counterparties available to utility special entities without providing an

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<sup>71</sup> See NFP Comment Letter.

<sup>72</sup> See City of Redding Comment Letter.

<sup>73</sup> See EEI, EDFTNA, Working Group, IECA, and NFP Comment Letters.

<sup>74</sup> See EDFTNA and Working Group Comment Letters.

associated benefit. The commenters believed that the substantial costs and burdens associated with registration as a swap dealer would likely cause an entity with even the slightest reservation regarding its ability to rely on the exclusion to err on the side of caution and decline to transact otherwise qualifying swaps with utility special entities.

The Commission has concluded that restrictions such as excluding financial entities from relying on the exclusion would have a chilling effect on some potential market participants who provide energy merchant services without providing significant regulatory benefits. Given that such entities would be subject to registration as a swap dealer if they exceed the \$8 billion General De Minimis Threshold, the Commission agrees that barring financial entities from taking advantage of the exclusion could thwart the purpose of the rulemaking while providing minimal additional regulatory protections. Therefore, the Commission is not adopting in Regulation 1.3(ggg)(4)(i)(B) any limitations on the persons who are permitted to rely upon the exclusion provided by the regulation.

#### **IV. Related Matters**

##### A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA)<sup>75</sup> requires that Federal agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, they must provide a regulatory flexibility analysis respecting the impact. Whenever an agency publishes a general notice of proposed rulemaking for any rule, pursuant to the notice-and-comment provisions of the

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<sup>75</sup> 5 U.S.C. 601 et seq.

Administrative Procedure Act<sup>76</sup> a regulatory flexibility analysis or certification typically is required.<sup>77</sup>

The Commission stated in the Proposal that the proposed amendments, if adopted, would not have a significant economic impact on affected persons because they would primarily relieve such persons from regulatory obligations (e.g., reporting, recordkeeping and business conduct requirements) that would otherwise apply to them if they had to register as swap dealers. The Commission further stated that to the extent that any small entities opted to rely on the exclusion, the notice requirement would not have a significant economic impact on those entities. Finally, it noted that the number of potential counterparties seeking to rely on the proposed exclusion may be limited, given the local nature of the relevant markets.

Accordingly, the Chairman, on behalf of the Commission, certified pursuant to 5 U.S.C. 605(b) that the Proposal will not have a significant economic impact on a substantial number of small entities.<sup>78</sup>

Two commenters addressed the Commission's RFA discussion.<sup>79</sup> Both commenters argued that the Commission's preliminary estimate that 100 persons would seek to rely upon the exclusion provided in Regulation 1.3(ggg)(4)(i)(B) was low, with one commenter positing that the Commission underestimated the number of counterparties by a factor of twenty.<sup>80</sup> The commenters argued that even an inconsequential notice filing could dissuade a potential counterparty from engaging in

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<sup>76</sup> 5 U.S.C. 553. The Administrative Procedure Act is found at 5 U.S.C. 500 et seq.

<sup>77</sup> See 5 U.S.C. 601(2), 603–05.

<sup>78</sup> 79 FR 31238 at 31243-31244.

<sup>79</sup> See NFP and IECA Comment Letters.

<sup>80</sup> This estimate is contained in NFP's letter to the Office of Information and Regulatory Affairs of the Office of Management and Budget concerning the Commission's PRA analysis. A copy of the letter is attached as Attachment C to the NFP Comment Letter.

swaps with a utility special entity, given the lack of any comparable filing requirement if the counterparty were to offer the same swap to an investor-owned utility. The commenters argued that the vast majority of utility special entities are small entities, and that the cumulative economic impact on those small entities would be significant.

In response, the Commission notes first that the RFA does not require the Commission to consider whether a proposed rulemaking will have a significant economic impact on persons indirectly affected by that rulemaking. The entities directly affected by the Amendments are counterparties to utility special entities, not the utility special entities themselves. Furthermore, the Commission is not required to conduct a full regulatory flexibility analysis under the RFA because the Amendments will not have a significant economic impact on any such small entities.

The Commission's preliminary estimate of the number of persons who would rely on Regulation 1.3(ggg)(4)(i)(B) was based on the information available to the Commission at the time and was provided with the hope of generating industry comment. The Commission questions the accuracy of the one commenter's estimate of the number of persons who will rely on Regulation 1.3(ggg)(4)(i)(B), which appears to have been based, at least in part, on a limited sampling of a handful of utility special entities and does not appear to sufficiently factor in the possibility that utility special entities may transact with many of the same counterparties. However, even accepting the commenter's estimate (which, for the reasons stated above, the Commission believes may be high), the Commission believes that the Amendments will not have a significant economic impact on small entities.

While it may be that some counterparties to utility special entities are small entities, not all of them may find need to rely on Regulation 1.3(ggg)(4)(i)(B). For example, counterparties who are small entities may be entering into swaps with utility special entities to hedge physical positions as set forth in Regulation 1.3(ggg)(6)(iii). Such swaps would not be counted toward any de minimis threshold.

For those small entities who, as counterparties to utility special entities, do rely on Regulation 1.3(ggg)(4)(i)(B), the Commission does not believe the burdens of Regulation 1.3(ggg)(4)(i)(B) will be significant. As discussed above, the Commission has not included in Regulation 1.3(ggg)(4)(i)(B) as adopted the proposed notice filing requirement. With respect to any recordkeeping obligations arising out of Regulation 1.3(ggg)(4)(i)(B), the Commission believes that many counterparties will rely on a representation by the utility special entity that it and the swap meet the requirements of the final regulation, and such a representation will most likely be included in swap documentation that a counterparty is already required to keep under existing regulations. Thus, the Commission believes that the economic impact resulting from the obligations imposed by the Amendments for record keeping purposes will not be significant.

#### B. Paperwork Reduction Act

The Paperwork Reduction Act (PRA)<sup>81</sup> provides that an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number from the Office of Management and Budget (OMB). The Proposal contained notification and recordkeeping requirements that are collections of

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<sup>81</sup> 44 U.S.C. 3501 et seq.

information within the meaning of the PRA. Accordingly, the Commission submitted the required information collection requests to OMB.

#### 1. Collections of Information

Regulation 1.3(ggg)(4)(i)(B) creates an exclusion from the Special Entity De Minimis Threshold with regard to specified swaps (utility operations-related swaps) entered into with a defined subset of special entities (utility special entities). As noted, the Proposal contained two elements that would qualify as collections of information. First, as proposed, a person seeking to rely on the exclusion would have been required to file a one-time notice, to be filed electronically with NFA, and containing the person's name, address, and a contact, as well as a signed representation that the person meets the criteria of the exclusion for utility operations-related swaps in Regulation 1.3(ggg)(4)(i)(B). Based upon the limited information available to the Commission at the time of the Proposal, the Commission preliminarily used a conservative estimate of 100 potential counterparties of utility special entities, estimated that the filing of the notice and ongoing verification of compliance would take 1.2 hours annually, and calculated an annual reporting burden of \$79,680. On that basis, the Commission requested a new collection of information control number from OMB and invited public comment on its paperwork burden calculations or the notice filing requirement.

Second, as proposed, Regulation 1.3(ggg)(4)(i)(B) also required a person seeking to rely on the proposed exclusion for utility operations-related swaps to maintain books and records in accordance with Regulation 1.31 to substantiate its eligibility. As noted above, the Commission preliminarily estimated that 100 persons may seek to rely on the exclusion for utility operations-related swaps, if adopted. The Commission estimated

that the recordkeeping requirement would take one hour annually, and calculated an annual recordkeeping burden of \$16,100. On this basis, the Commission submitted a request to amend OMB Control Number 3038-0090 and invited public comment on its paperwork burden calculations and the recordkeeping requirement.

## 2. Information Collection Comments

The Commission invited comment on any aspect of the information collection requirements discussed in the Proposal. One commenter addressed the Commission's PRA estimates.<sup>82</sup> The commenter expressed the view that the Commission had failed to explain the need for the notice filing requirement or the ways in which the Commission would use the information so obtained, and predicted that the costs of utility operations-related swaps would be increased due to regulatory risk to potential counterparties, costs of collecting data, and arranging to file the notice with NFA. The commenter further stated that the Commission had not identified the additional books or records that would be required to be kept, over and above the existing requirements applicable to persons engaging in swaps, or how the Commission would use that additional information. Moreover, the commenter asserted that the Commission had underestimated the gross annual reporting burden by a factor of twenty.

In response to these comments, the Commission notes that in adopting Regulation 1.3(ggg)(4)(i)(B) it has made significant changes to the regulation as proposed. After consideration of the comments received, and as stated above, the Commission has determined not to adopt in Regulation 1.3(ggg)(4)(i)(B) a notice filing requirement.

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<sup>82</sup> See NFP Comment Letter.

This eliminates the first collection described above.<sup>83</sup> In addition, as adopted, Regulation 1.3(ggg)(4)(i)(B)(4) permits a person to rely upon a written representation obtained from a utility special entity that it is a utility special entity under the regulation, and that the swap the person engages in with the utility special entity is a utility operations-related swap. The regulation does not, then, contain a general recordkeeping requirement to substantiate a person's eligibility to rely on the exclusion. Instead, the only recordkeeping requirement the Commission has adopted is that the person keep, in accordance with Regulation 1.31, any written representations the person may have obtained from utility special entities in accordance with Regulation 1.3(ggg)(4)(i)(B)(4) as adopted. As commenters noted, counterparties to swaps are already subject to recordkeeping requirements under Part 45 of the Commission's regulations, and those requirements, together with the requirement in Regulation 1.3(ggg)(4)(i)(B)(4) to retain any such written representations, should be sufficient for the Commission's compliance purposes. This is a reduction from the paperwork burden for the second collection described above and as proposed.

The PRA requires, in part, that each collection of information submitted to OMB is necessary for the proper performance of the functions of the agency, including that the information has practical utility. In the submissions to OMB for the Proposal, the Commission identified the reasons why the collection is necessary for the agency and how it will use the information.

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<sup>83</sup> In response to the Commission's request for a new control number for this collection, OMB granted new OMB Control Number 3038-0109. However, because the Commission has determined not to adopt the proposed notice filing requirement, Commission staff will request that OMB discontinue that control number.

The requirement to keep a record of the written representation that a counterparty obtains from a utility special entity and on which the counterparty relies in determining that it is eligible for the exclusion in Regulation 1.3(ggg)(4)(i)(B) will enable the Commission to quickly and efficiently confirm that persons relying on the exclusion are eligible to rely on the exclusion.

As the Commission stated in the Proposal, the number of 100 potential respondents for PRA purposes (i.e., counterparties to engage in utility operations-related swaps with utility special entities) was a preliminary and conservative estimate based on the limited information available to the Commission at the time. One commenter argued that this estimate understated the actual PRA burden by a factor of 20.<sup>84</sup> As mentioned above, the Commission questions the accuracy of this estimate, which appears to have been based, at least in part, on a limited sampling of a handful of utility special entities and does not appear to sufficiently factor in the possibility that utility special entities may transact with many of the same counterparties. Nevertheless, the Commission has recalculated its PRA burden estimates using the commenter's estimate. The recalculation takes into account the Commission's determination not to adopt in Regulation 1.3(ggg)(4)(i)(B) the proposed notice filing requirement. The recalculation also takes into account a reduction in the estimate from the Proposal of the average burden hours due to the Commission's belief that any additional recordkeeping costs imposed by the Amendments are likely to be small, as most of the costs are most likely already being incurred.<sup>85</sup>

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<sup>84</sup> See NFP Comment Letter.

<sup>85</sup> The Commission believes that the costs that are already being incurred include costs to the person using the exclusion to monitor its swap trading activity with special entities. Prior to the adoption of this

Accordingly, the Commission has recalculated the estimated burden from that set forth in the Proposal, using an estimate of 2,000 respondents and reducing the annual burden hours<sup>86</sup> by half, as follows:

Recordkeeping requirement:

Number of Respondents: 2,000.

Frequency of Response: Annually.

Average Burden Hours per Response: 0.5.

Estimated gross annual reporting burden: \$161,000.

On this basis, the Commission is amending its requests to OMB with respect to Control Number 3038-0090 for the recordkeeping requirement.

### C. Cost-Benefit Considerations

CEA Section 15(a) requires the Commission to consider the costs and benefits of its actions before promulgating a regulation under the CEA or issuing certain orders.

CEA Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission considers the costs and benefits resulting from its discretionary determinations with respect to the Section 15(a) factors, and seeks

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exclusion, these persons would be subject to registration as a swap dealer if their swap dealing exceeded the Special Entity De Minimis Threshold. Therefore, these persons are likely already monitoring their dealing activity with all special entities. The additional costs would only be the cost of separately monitoring their dealing in utility operations-related swaps with utility special entities.

<sup>86</sup> The hourly rate used in the burden estimate of the recordkeeping requirement is the same as the hourly rate for a financial analyst (\$161/hour), which was used for purposes of the Commission's cost benefit considerations in the swap dealer definition regulations that are being amended by the Amendments. See 77 FR at 30715, n.1359.

comments from interested persons regarding the nature and extent of such costs and benefits.

1. Background. The Commission is amending its regulations to permit a person to exclude utility operations-related swaps with utility special entities in calculating the aggregate gross notional amount of the person's swap positions for purposes of the Special Entity De Minimis Threshold.

As discussed above, CEA Section 1a(49) defines the term "swap dealer," and Regulation 1.3(ggg) further defines that term. A person who comes within the swap dealer definition is subject to registration as such with the Commission and the regulatory requirements applicable to swap dealers.<sup>87</sup> Regulation 1.3(ggg)(4)(i) provides an exception from the swap dealer definition for persons who engage in a de minimis amount of swap dealing activity. Without the adoption of Regulation 1.3(ggg)(4)(i)(B), persons who engage in swap dealing activity with special entities, including utility special entities, are excepted from the swap dealer definition so long as the swap positions connected with those dealing activities into which the person enters over the course of the immediately preceding 12 months have an aggregate gross notional amount of no more than \$25 million (i.e., the Special Entity De Minimis Threshold). These regulatory provisions set the baseline for the Commission's consideration of the costs and benefits of the Amendments. That is, the Commission considered the costs and benefits that would result from allowing persons to exclude utility operations-related swaps with utility special entities from the Special Entity De Minimis Threshold (\$25 million), such that the de minimis threshold with respect to such swaps would be the same as for swaps

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<sup>87</sup> See, e.g., Part 23 of the Commission's regulations.

not involving a special entity (i.e., the General De Minimis Threshold, currently set at \$8 billion), subject to the requirements set forth in the Amendments.<sup>88</sup>

The Commission invited comments from the public on all aspects of its preliminary consideration of costs and benefits associated with the Proposal, and the Cost-Benefit Considerations section of the Proposal was followed by a set of specific questions. While those who commented on the Proposal did not specifically address the Cost-Benefit Considerations section of the Proposal, certain of the comments raised issues with respect to the Commission's cost-benefit considerations. Accordingly, although the Commission has addressed those comments above in connection with the specific proposed regulatory provision of the Amendments to which they referred, the Commission is also referencing those comments in the discussion that follows.

2. Costs. As noted by the Commission in the Swap Dealer Definition Adopting Release, “a de minimis exception, by its nature, will eliminate key counterparty protections provided by Title VII for particular users of swaps . . . [and] [t]he broader the exception, the greater the loss of protection.”<sup>89</sup> In adopting the Special Entity De Minimis Threshold, the Commission explained that the \$25 million threshold was “appropriate in light of the special protections that Title VII affords to special entities.”

The Commission also recognized the “serious concerns raised by commenters” regarding

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<sup>88</sup> While Staff Letter 14-34 provided no-action relief in certain circumstances, and subject to certain requirements, that are similar to those of the Amendments, the Commission believes that Staff Letter 14-34 did not set or affect the baseline from which the Commission considered the costs and benefits of the Proposal. This is because Staff Letter 14-34 only stated the position of the Division that it would not recommend enforcement action to the Commission and, further, that the letter and the positions taken therein do not necessarily represent the position or view of the Commission or any other office or division of the Commission.

<sup>89</sup> See 77 FR at 30596, 30627-30628.

the application of the de minimis exception to swap dealing with special entities in light of losses that special entities have incurred in the financial markets.<sup>90</sup>

One effect of the Amendments is that a greater quantity of swap dealing with utility special entities will potentially be undertaken without the benefits to utility special entities of that dealing activity being subject to swap dealer regulation.<sup>91</sup> In addition, the Amendments will impose costs associated with ascertaining whether a person is eligible to rely on the proposed exclusion for utility operations-related swaps. Finally, to the extent that a person relying on the exclusion would be required to keep books and records it would not otherwise keep, that represents another potential cost. The Commission invited comment regarding the extent of all of these costs, and any other costs that would result from adoption of the Proposal, including estimates of monetary or other measurements thereof.

Certain comments characterized the compliance and other costs of making the notice filing and keeping the books and records called for under the Proposal as excessive, not justified, and likely to deter counterparties from engaging in swaps with utility special entities.<sup>92</sup> As noted above, the Commission has determined not to adopt the proposed notice filing requirement, and has reduced the scope of the recordkeeping requirement under the final regulation to only include a requirement to keep the written representations, if any, from utility special entities.<sup>93</sup> As a result, the costs associated with the proposed notice requirement have been eliminated, and the Commission believes

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<sup>90</sup> See 77 FR at 30633.

<sup>91</sup> See 77 FR at 30707 (stating that the benefits of swap dealing regulation include customer protection, market orderliness and market transparency).

<sup>92</sup> See, e.g., NFP and IECA Comment Letters.

<sup>93</sup> The Commission notes that acquiring written representations to verify that a counterparty is a utility special entity and the swap is a utility operations-related swap in accordance with Regulation 1.3(ggg)(4)(i)(B)(4) is elective.

the costs associated with the recordkeeping requirement on an individual basis will be less than the estimate contained in the Proposal.<sup>94</sup>

3. Benefits. With respect to benefits, the Commission explained in the Proposal its belief that the exclusion in Regulation 1.3(ggg)(4)(i)(B) will benefit utility special entities and the public by encouraging a greater number of prospective counterparties to engage with utility special entities in utility operations-related swaps.<sup>95</sup> Because of the local and particularized nature of electric and natural gas production and distribution, the number of potential swap counterparties for utility special entities seeking to hedge commercial risk is more limited than for other special entities seeking to hedge non-physical commodities. The number of counterparties to utility special entities may be further limited due to the unique obligation of these utilities to provide continuous service to the public. These considerations may be more critical given the important role energy services play in public safety and commerce. Thus, potentially increasing the number of counterparties to utility special entities may be in the public interest.

Accordingly, increasing the number of potential counterparties available for utility special entities to engage in operations-related hedging transactions may (i) result in a lower cost to hedge (i.e., lower spreads) and (ii) enable utility special entities to better manage their business. This should, in turn, help utility special entities meet their obligations to provide continuous services to the public in a cost-effective manner, and will help protect the public interest and safety that is dependent on such energy services.

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<sup>94</sup> The Commission has provided above an estimate of the annual costs associated with the recordkeeping requirement for purposes of the PRA.

<sup>95</sup> The Commission explained in the Swap Dealer Definition Adopting Release that “[i]n principle, a higher [de minimis] threshold would promote a larger pool of swap-dealing entities (since entities with swap dealing activity below the threshold need not incur costs to comply with swap dealer regulations), meaning more potential counterparties available to swap users.” See 77 FR at 30707.

The Commission sought comments regarding these benefits and any other benefits resulting from adoption of the Proposal, and to the extent they can be quantified, estimates of the monetary or other value thereof.

While commenters did not specifically address the Commission's consideration of the costs and benefits of the Proposal, certain of the comments raise issues with respect to the Commission's costs and benefits considerations. Specifically, as discussed with respect to the comments the Commission received on its RFA analysis, the proper baseline from which to consider the costs and benefits of the regulation is the state of affairs at the time the regulation is to be adopted (i.e., a counterparty to a utility special entity is required to register as a swap dealer if they exceed the Special Entity De Minimis Threshold). Registration as a swap dealer entails costs that a person who can take advantage of the exclusion in Regulation 1.3(ggg)(4)(i)(B) would not have to incur.

As noted above, some of the commenters were of the view that the notice filing and recordkeeping requirements are unjustified or inadequately supported by the explanation in the Proposal. The commenters further stated that the Commission could monitor use of the exclusion by using existing data reported to the SDRs. As noted above, the Commission has not included a notice filing requirement in Regulation 1.3(ggg)(4)(i)(B) as adopted. As a result, the costs associated with the notice filing requirement that were identified in the Proposal have been eliminated.

Although there are additional costs associated with maintaining records pertaining to the use of the exclusion, such costs are likely to be incremental since most persons relying on the exclusion are likely to rely on a representation from their counterparty, a utility special entity, that it qualifies as a utility special entity and that the swap

transaction is a utility operations-related swap within the meaning of the final regulation. Such a representation would likely be added to the swap documentation that counterparties are already required to maintain under existing regulations or that they maintain in the normal course of their business.

The general recordkeeping requirement that was included in the Proposal has been reduced to a requirement to retain only the written representations, if any, that a person receives from a utility special entity. Accordingly, the recordkeeping costs of the Amendments on an individual basis will be less than as estimated in the Proposal. The requirement to keep those written representations will enable the Commission to quickly and efficiently confirm that persons relying on the exclusion are eligible to rely on the exclusion.

Additionally, expanding the definition of utility operations-related swap to include swaps related to certain agricultural commodities will provide benefits to utility special entities that use such swaps in their normal operations, and in a manner consistent with the purposes of the regulation. However, the Commission notes that there may be costs associated with expanding the definition. Specifically, an overbroad definition that does not properly balance the need to provide additional regulatory protections for special entities, including utility special entities, against the policies for the exclusion would be contrary to the public interest.

4. Section 15(a). Section 15(a) of the CEA requires the Commission to consider the effects of its actions in light of the following five factors:

a. Protection of Market Participants and the Public. Again, as noted by the Commission in the Swap Dealer Definition Adopting Release, “a de minimis exception,

by its nature, will eliminate key counterparty protections provided by Title VII for particular users of swaps . . . [and] [t]he broader the exception, the greater the loss of protection.”<sup>96</sup> In adopting the Special Entity De Minimis Threshold, the Commission explained that the \$25 million threshold was “appropriate in light of the special protections that Title VII affords to special entities.”<sup>97</sup> The Commission also recognized the “serious concerns raised by commenters” regarding the application of the de minimis exception to swap dealing with special entities in light of losses that special entities had incurred in the financial markets in connection with the 2008 financial crisis.<sup>98</sup> By allowing more persons who are not registered as swap dealers to engage in certain swaps with utility special entities, fewer special entities will have the benefit of the special entity protections as a result of the Amendments. However, given the narrow tailoring of the exclusion and the requirements persons must meet to rely on the exclusion, the Commission believes the costs of such reduced protections to the affected utilities, market participants and the public may be limited. Moreover, these costs will be counteracted by the benefits the Amendments will provide to utility special entities and the public, namely, enabling utility special entities to efficiently hedge and manage risk, and to meet their obligations to provide vital energy services to the public in a consistent and cost-effective manner.

b. Efficiency, Competitiveness, and Financial Integrity of Markets. The Commission believes that the Amendments will enhance efficiency and competitiveness in the electricity and natural gas markets by encouraging prospective counterparties to

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<sup>96</sup> 77 FR at 30596, 30627-30628.

<sup>97</sup> Id. at 30633.

<sup>98</sup> Id.

engage in swap transactions with utility special entities. The availability of additional swap counterparties in these markets will enhance competition between counterparties, which will, in turn, benefit utility special entities by potentially lowering their transaction costs. Further, because the exclusion is narrowly tailored, the Commission believes that removing the protections provided by swap dealer registration and regulation for some utility special entity counterparties will not noticeably impact the integrity of the swaps market.

c. Price Discovery. It is unlikely that facilitating more counterparties for utility special entities to trade with will have a significant impact on price discovery. Price discovery is the process by which prices for underlying commodities may be determined or inferred through market prices. The addition of more counterparties willing to trade with utility special entities may improve, and should not adversely impact, the prices that the utility special entities receive on their swap contract transactions. Better pricing might enhance price discovery if the bid-ask spreads in transactions involving utility special entities narrow due to more competition, but the Commission cannot be sure this will be the case as the potential improved pricing might not occur or could be negligible.

d. Sound Risk Management. The Commission believes that if counterparties refrain from transacting in swaps with utility special entities because of the regulatory costs associated with swap dealer registration and regulation, the ability of utility special entities to hedge commercial risks will be impaired, particularly in cases for which the number of counterparties available becomes very limited. Mitigating the costs and regulatory concerns of potential counterparties by permitting them to transact with utility

special entities without being subject to swap dealer registration and regulation will enable utility special entities to better manage their commercial risk.

e. Other Public Interest Considerations. As discussed above, the Commission believes the Amendments will enable utility special entities to practice sound, cost-effective risk management and to more effectively operate and conduct their business. This may, in turn, help utility special entities meet their obligations to provide continuous services to the public in a more cost-effective manner.

List of Subjects in 17 CFR Part 1

De minimis exception, Registration, Special Entities, Swap dealers, Swaps, Utility operations-related swaps, Utility special entities.

For the reasons discussed in the preamble, the Commission amends 17 CFR part 1 as follows:

## **PART 1 – GENERAL REGULATIONS UNDER THE COMMODITY**

### **EXCHANGE ACT**

1. The authority citation for part 1 is revised to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6k, 6l, 6m, 6n, 6o, 6p, 6r, 6s, 7, 7a-1, 7a-2, 7b, 7b-3, 8, 9, 10a, 12, 12a, 12c, 13a, 13a-1, 16, 16a, 19, 21, 23, and 24 (2012).

2. In § 1.3, revise paragraph (ggg)(4)(i) to read as follows:

#### **§ 1.3 Definitions.**

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(ggg) \* \* \*

(4) De minimis exception—(i)(A) In General. Except as provided in paragraph (ggg)(4)(vi) of this section, a person that is not currently registered as a swap dealer shall

be deemed not to be a swap dealer as a result of its swap dealing activity involving counterparties, so long as the swap positions connected with those dealing activities into which the person—or any other entity controlling, controlled by or under common control with the person—enters over the course of the immediately preceding 12 months (or following the effective date of final rules implementing Section 1a(47) of the Act, 7 U.S.C. 1a(47), if that period is less than 12 months) have an aggregate gross notional amount of no more than \$3 billion, subject to a phase in level of an aggregate gross notional amount of no more than \$8 billion applied in accordance with paragraph (ggg)(4)(ii) of this section, and an aggregate gross notional amount of no more than \$25 million with regard to swaps in which the counterparty is a “special entity” (as that term is defined in Section 4s(h)(2)(C) of the Act, 7 U.S.C. 6s(h)(2)(C), and § 23.401(c) of this chapter), except as provided in paragraph (ggg)(4)(i)(B) of this section. For purposes of this paragraph, if the stated notional amount of a swap is leveraged or enhanced by the structure of the swap, the calculation shall be based on the effective notional amount of the swap rather than on the stated notional amount.

(B) Utility Special Entities. (1) Solely for purposes of determining whether a person’s swap dealing activity has exceeded the \$25 million aggregate gross notional amount threshold set forth in paragraph (ggg)(4)(i)(A) of this section for swaps in which the counterparty is a special entity, a person may exclude “utility operations-related swaps” in which the counterparty is a “utility special entity.”

(2) For purposes of this paragraph (4)(i)(B), a “utility special entity” is a special entity, as that term is defined in Section 4s(h)(2)(C) of the Act, 7 U.S.C. 6s(h)(2)(C), and § 23.401(c) of this chapter, that:

- (i) Owns or operates electric or natural gas facilities, electric or natural gas operations or anticipated electric or natural gas facilities or operations;
- (ii) Supplies natural gas or electric energy to other utility special entities;
- (iii) Has public service obligations or anticipated public service obligations under Federal, State or local law or regulation to deliver electric energy or natural gas service to utility customers; or
- (iv) Is a Federal power marketing agency as defined in Section 3 of the Federal Power Act, 16 U.S.C. 796(19).

(3) For purposes of this paragraph (ggg)(4)(i)(B), a “utility operations-related swap” is a swap that meets the following conditions:

- (i) A party to the swap is a utility special entity;
- (ii) A utility special entity is using the swap to hedge or mitigate commercial risk as defined in § 50.50(c) of this chapter;
- (iii) The swap is related to an exempt commodity, as that term is defined in Section 1a(20) of the Act, 7 U.S.C. 1a(20), or to an agricultural commodity insofar as such agricultural commodity is used for fuel for generation of electricity or is otherwise used in the normal operations of the utility special entity; and
- (iv) The swap is an electric energy or natural gas swap, or the swap is associated with: the generation, production, purchase or sale of natural gas or electric energy, the supply of natural gas or electric energy to a utility special entity, or the delivery of natural gas or electric energy service to customers of a utility special entity; fuel supply for the facilities or operations of a utility special entity; compliance with an electric system reliability obligation; or compliance with an energy, energy efficiency, conservation, or

renewable energy or environmental statute, regulation, or government order applicable to a utility special entity.

(4) A person seeking to rely on the exclusion in paragraph (ggg)(4)(i)(B)(1) of this section may rely on the written representations of the utility special entity that it is a utility special entity and that the swap is a utility operations-related swap, as such terms are defined in paragraphs (ggg)(4)(i)(B)(2) and (3) of this section, respectively, unless it has information that would cause a reasonable person to question the accuracy of the representation. The person must keep such representation in accordance with § 1.31.

\* \* \* \* \*

Issued in Washington, DC, on September 23, 2014, by the Commission.

Christopher J. Kirkpatrick,

Secretary of the Commission.

Note: The following appendices will not appear in the Code of Federal Regulations.

**Appendices to Exclusion of Utility Operations-Related Swaps with Utility Special Entities from De Minimis Threshold for Swaps with Special Entities – Commission Voting Summary and Chairman’s Statement**

**Appendix 1 – Commission Voting Summary**

On this matter, Chairman Massad and Commissioners Wetjen, Bowen, and Giancarlo voted in the affirmative. No Commissioner voted in the negative.

**Appendix 2 – Statement of Chairman Timothy G. Massad**

I support this final rule pertaining to the swap activities of small utility companies. These companies are responsible for keeping the lights on in communities

across our country, for heating and cooling our homes, and powering the kitchen appliances that we use every day to feed our families. To do their job, they must manage the risk of their own fuel costs, and to do that, they must be able to access the energy commodity markets. This final rule will help make sure they can do so.

In the Dodd-Frank Act, Congress directed the Commission to impose heightened standards on swap dealers in their swap activities with Federal, state and municipal government agencies and certain other so-called “special entities.” This was in response to the instances where swap dealers may have failed to disclose material risks of swap transactions to municipal entities or otherwise acted improperly, which often resulted in massive losses to the municipality.

Because Congress defined “special entity” broadly, when the Commission implemented this Congressional directive through a previous rulemaking, the rule was applied to many utility companies that are government-owned. These companies, which serve communities across our nation, engage in energy swaps. The counterparties with whom they transact business were often not registered swap dealers, nor were they the dealers that engaged in the abusive practices that led to Congress’s concerns. The imposition of these requirements through a designation as a swap dealer could unduly burden their business and thereby threaten the ability of our local utility companies to manage their risks. This rule fixes that problem.

This final rule benefited from public comment. In key respects, we made adjustments to our initial proposal to address concerns raised during the notice and comment process.

Implementing this final rule is an important step in our effort to finish the job of implementing the Dodd-Frank Act and will help us achieve the full benefit of the new regulatory framework, while at the same time protecting the interests of—and minimizing the burdens on—commercial end-users who depend on the derivatives markets to hedge normal business risks.