The *De Minimis* Exception Perspectives of Commercial Firms

Presentation to the CFTC’s Energy & Environmental Markets Advisory Committee

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Recommendation

• EEMAC should recommend
  – CFTC issue an interim final rule setting the *de minimis* threshold at $8 billion – as soon as possible
  – CFTC dramatically improve the information it receives before taking any other action regarding the *de minimis* threshold
  – CFTC identify specific regulatory objectives that are not sufficiently met with a *de minimis* threshold at $8 billion
  – CFTC issue a final capital rule
Concerns

• Automatic drop in *de minimis* threshold
  – does not materially advance any policy objective and
  – harms the commercial markets

• Alterations to the current definition and interpretations of “swap dealing”

• Lack of regulatory certainty for business planning
An $8 Billion Threshold

• It works well
  – Encompasses a significant amount of the OTC market
  – About 78% of all OTC commodity swaps involved a registered swap dealer

• Meets regulatory objectives

• Commercial market has planned and built compliance infrastructure to this threshold
Lowering the *De Minimis* Threshold

- Regulatory costs in chasing a very small portion of the market
- Likely outcome is severe harm to the commodity markets
  - Natural business decision to lessen swap dealing
  - Decrease in liquidity, Increase in concentration
  - Increased hedging costs
  - Volatility in commodity prices
The Utility Special Entity Problem

• Loss of liquidity as commercial counterparties would no longer trade with special entity
  – Ex: one special entity lost 2 of its 3 largest end-user counterparties following the implementation of the *de minimis* threshold for special entities, greatly diminishing its ability to hedge, and subjecting it to wider bid ask spreads.

  • APPA testimony before House Agricultural Committee (Mar. 2013)
The Commodity Swap Markets

• Very small slice of the global derivatives markets
• There is no finding that commercial firms create systemic risk
• Bilateral market structure
  – Not every transaction involves swap dealing
• For many commercials – swap dealing is ancillary to their physical business
Bilateral OTC Swaps

• Bilateral OTC market also plays a valuable role for customized hedging
  – Allows physical market players to optimize credit relationships / collateral efficiency
  – “Natural” longs and shorts can often hedge efficiently between each other, without either acting as a “Dealer”
Bilateral Swap Example

• In this example a natural “long” (power generator) and a natural “short” (electricity supplier) enter into a swap that serves as a hedge for both parties.

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<th>SUPPLIER</th>
<th>CUSTOMERS</th>
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Information Problems

• No party currently has the information necessary to make informed decisions about the *de minimis* threshold and the commodity derivatives markets

• Good information is critical path

• Far better for the CFTC to collect and analyze pertinent information than debate the use of other swap dealer metrics
The Preliminary Report

• Demonstrates the need for better information
• The Counterparty and Transaction Count methods are flawed
  – Would effectively alter the definition of “swap dealer”
• Over inclusive of trading and speculative transactions
• Multiple tier analysis and regulation are flawed
Final Thoughts

• $8 Billion *de minimis* threshold works

• Interim Final Rule to prevent the drop
  – Protection for markets that are critical to the commodity supply chain in the United States

• CFTC must gather more information

• CFTC must finish the critical rules

• Only then, engage in informed decisions