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**Sent:** Monday, November 22, 2010 6:25 PM  
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**Cc:** Dondanville, Patricia <pdondanville@schiffhardin.com>  
**Subject:** Pre-NOPR Comments to End User Exception Task Force (XI)  
**Attach:** Comment Letter to End User Exception Task Force, dated November 22, 2010.pdf

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Ladies and Gentlemen:

Attached please find a comment letter filed on behalf of the following entities:

- National Rural Electric Cooperative Association;
- American Public Power Association;
- American Public Gas Association; and
- Large Public Power Council.

Thank you.

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## **END USER EXCEPTION TASK FORCE**

November 22, 2010

David Stawick, Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington, D.C. 20581

Submitted electronically pursuant to the CFTC website protocol

**Re: Pre-NOPR Comments to End User Exception Task Force (XI)  
under Title VII of the  
Dodd-Frank Wall Street Reform and Consumer Protection Act**

Dear Mr. Stawick:

The trade associations comprising the “Not-For-Profit Energy End User Coalition” (the “Coalition”) respectfully submit these comments to the Commodity Futures Trading Commission (the “CFTC”) Task Force XI (the “End User Exception Task Force”) established as part of the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”). Given the nature of our members’ commercial enterprises,<sup>1</sup> our comments focus on those aspects of the End User Exception Task Force’s rule-makings that will affect end users of energy and energy-related commodities and “swaps.”<sup>2</sup>

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<sup>1</sup> The comments contained in this filing represent the comments and recommendations of the organizations comprising the “Coalition,” but not necessarily the views of any particular member with respect to any issue.

<sup>2</sup> We have footnoted this term, and direct the reader to our comments dated September 20, 2010, submitted in response to the “Definitions ANOPR,” and in particular to our comments on the definition of “swap”. A copy is attached for convenience of reference. Given the broad definition of “swap” and the fact that everyday commercial transactions of the NFP Energy End

We appreciate the opportunity to submit these comments in advance of the End User Exception Task Force's rule-makings. As the CFTC (along with the Securities and Exchange Commission and the prudential regulators) embarks on the complex and interrelated rule-makings necessary to implement the Act, the Coalition thanks the CFTC for its consideration of the impact of these rule-makings on our enterprises, which are "end users" of commodities and swaps. We appreciate that the Act's purpose is to provide increased regulatory oversight of financial entities. However, it is equally important that end users have certainty with respect to the impact of the rules on their enterprises. The rule-makings should not impose on end users new regulatory costs and burdens which are unnecessary to achieve the Act's goals of increased market oversight, reduction of systemic risk, increased price transparency and financially-sound trading markets for swaps.

## **I. THE COALITION MEMBERS<sup>3</sup>**

The Coalition is comprised of four trade associations representing the interests of not-for-profit, consumer-owned electric and gas utilities in the United States (collectively, the "NFP Energy End Users"). The primary enterprise of these NFP Energy End Users has been for well over 75 years, and still is today, to provide reliable natural gas and/or electric energy to their retail consumer customers every hour of the day and every season of the year, keeping costs low and supply predictable, while practicing environmental stewardship. The NFP Energy End Users are public service entities, owned by and accountable to the American consumers they serve.

### **A. NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION ("NRECA")**

Formed in 1942, NRECA is the national service organization for more than 900 not-for-profit rural electric utilities and public power districts that provide electric energy to approximately 42 million consumers in 47 states or 12 percent of the nation's population. Kilowatt-hour sales by rural electric cooperatives account for approximately 11 percent of all electric energy sold in the United States. NRECA members generate approximately 50 percent of the electric energy they sell and purchase the remaining 50 percent from non-NRECA members. The vast majority of NRECA members are not-for-profit, consumer-owned cooperatives which distribute electricity to consumers. NRECA's members also include

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Users may arguably fall within that definition, the regulatory burdens imposed on end users of "swaps" are of significant concern to NFP Energy End Users.

<sup>3</sup> The Coalition is grateful to the following organizations and associated entities who are active in the legislative and regulatory policy arena in support of the NFP Energy End Users, and who have provided considerable assistance and support in developing these comments. The Coalition is authorized to note the involvement of these organizations and associated entities to the CFTC, and to indicate their full support of these comments and recommendations: the Transmission Access Policy Study Group (an informal association of transmission dependent electric utilities located in more than 30 states), ACES Power Marketing and The Energy Authority.

approximately 66 generation and transmission (“G&T”) cooperatives, which generate and transmit power to 668 of the 846 distribution cooperatives. The G&T cooperatives are owned by the distribution cooperatives they serve. Remaining distribution cooperatives receive power directly from other generation sources within the electric utility sector. Both distribution and G&T cooperatives were formed to provide reliable electric service to their owner-members at the lowest reasonable cost. All these cooperatives work together pursuant to their common public service mandate from their members, often without the type of contracts that exist between for-profit entities. Rather, many cooperatives deal with each other under take and pay “all requirements contracts” which set forth the terms of service/energy sales, but not necessarily the price for such service/energy sales. For example, as between a G&T cooperative and its distribution cooperative owner-members, the price is often determined based on a “cost of service” rate, with no market price component.

Electric cooperatives own approximately 43% of the distribution lines in the U.S., reaching some of the country’s most sparsely populated areas, from Alaskan fishing villages to remote dairy farms in Vermont. In an electric cooperative, unlike most electric utilities, its owners -- called “members” of the cooperative -- are also customers, who are able to vote on policy decisions, directors and stand for election to the board of directors. Because its members are customers of the cooperative, all the costs of the cooperative are directly borne by its consumer-members.

The vast majority of NRECA’s members meet the definition of “small entities” under the Small Business Regulatory Enforcement Fairness Act (“SBREFA”). 5 U.S.C. §§ 601-612 (as amended Mar. 29, 1996). Only four distribution cooperatives and approximately 28 G&Ts do not meet the definition. The RFA incorporates by reference the definition of “small entity” adopted by the Small Business Administration (the “SBA”). The SBA’s small business size regulations state that entities which provide electric services are “small entities” if their total electric output for the preceding fiscal year did not exceed 4 million megawatt hours. 13 C.F.R. §121.201, n.1.

#### B. AMERICAN PUBLIC POWER ASSOCIATION (“APPA”)

APPA is the national service organization representing the interests of publicly-owned electric utilities in the United States. More than 2,000 public power systems provide over 15 percent of all kilowatt-hour sales to ultimate customers and serve 45 million people. APPA’s member utilities are not-for-profit utility systems that were created by state or local governments to serve the public interest. These systems take various forms, including departments of a municipality; a utility board or a public utility district formed under state or local law; a joint action agency or joint power agency formed under state law to provide wholesale power supply and transmission service to distribution entity members; a state agency, authority or instrumentality; or other type of political subdivision of a state. Like the members of NRECA, the vast majority of APPA’s members are considered “small entities” under SBREFA.

Public power utilities perform a variety of electric utility functions. Some generate, transmit, and sell power at wholesale and retail, while others purchase power and distribute it to

retail customers, and still others perform all or a combination of these functions. All these systems work together pursuant to their common statutory and regulatory mandates. Some are “vertically integrated” electric utilities (engaging in generation, transmission, distribution and retail sales), while others are vertically integrated by contract with other “201(f) entities” (entities that are exempt from full Federal Power Act rate regulation under Section 201(f) of that statute), or by contract with third parties.

Public power utilities are accountable to elected and/or appointed officials and, ultimately, the American public. The focus of a public power utility is to provide reliable, safe electricity service, keeping costs low and predictable for its customers, while practicing good environmental stewardship.

#### C. AMERICAN PUBLIC GAS ASSOCIATION (“APGA”)

The APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and over 720 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities. The purpose of a public gas system is to provide reliable, safe and affordable natural gas service to the community it serves. Public gas systems depend on the physical commodity markets, as well as financial market transactions, to meet the needs of their consumers. Together, these markets play a central role in public gas utilities securing natural gas supplies at reasonable and stable prices. Specifically, many public gas utilities purchase firm gas supplies in the physical delivery market at prevailing market prices, and enter into OTC derivatives customized to meet their specific needs to hedge their customers’ exposure to future market price fluctuations and stabilize rates. As with APPA-member systems, the APGA members work together pursuant to their common statutory and regulatory mandates, often without the types of contracts that exist between for-profit entities, but instead under tariff arrangements or all requirements contracts. Like the members of NRECA and APPA, the vast majority of APGA’s members are considered “small entities” under SBREFA. APGA members are “small entities” because nearly all have fewer than 500 employees. 13 C.F.R. §121.201.

#### D. LARGE PUBLIC POWER COUNCIL (“LPPC”)

The Large Public Power Council is an organization representing 24 of the largest locally owned and operated public power systems in the nation. LPPC members own and operate over 75,000 megawatts of generation capacity and nearly 34,000 circuit miles of high voltage transmission lines. Collectively, LPPC members own nearly 90% of the transmission investment owned by non-federal public power entities in the U.S. Our member utilities supply power to some of the fastest growing urban and rural residential markets in the country. Members are located in 11 states and Puerto Rico -- and provide power to some of the largest cities in the country including Los Angeles, Seattle, Omaha, Phoenix, Sacramento, Jacksonville, San Antonio, Orlando and Austin.

Members of the LPPC are also members of APPA. LPPC members are larger in size than other APPA members due to the size and population density of the communities to which they provide power. LPPC members often require larger, more complex and more diverse types of resources to serve their communities as well, and therefore LPPC members own and operate more complex generation and transmission assets than many other APPA members. However, despite being larger in size and resources, LPPC members' public service mission remains the same -- to provide reliable, safe electricity service, keeping costs low and predictable for its customers while practicing environmental stewardship.

E. THE COALITION'S MEMBERS ARE UNIQUE, AS ARE THE "MARKETS" IN WHICH THEY TRANSACT AND THE TRANSACTIONS IN WHICH THEY ENGAGE.

The NFP Energy End Users represented by the Coalition include public power utilities, public gas utilities and rural electric cooperatives. Some are quite large, but most of these NFP Energy End Users are very small, reflecting the communities they serve, the success of those communities in providing reliable essential services for their citizens at the lowest reasonable rates and, in the case of rural electric cooperatives, the contribution to Americans' quality of life of the Rural Electrification Act of 1936.

Some NFP Energy End Users generate, transmit and sell electric energy to their fellow public power systems and cooperatives and to third parties at wholesale, while others purchase natural gas and/or electric energy (from associated public power systems and cooperatives or from third parties), and distribute it to retail consumers. Still others perform all or a combination of these commercial functions. The Coalition's members are unique among "end users" whose transactions are potentially subject to CFTC regulation as "swaps" (even among those who are "end users" of energy and energy-related commodities and swaps) in that the public power and gas entities which are NFP Energy End Users have no stockholders and are accountable to elected and/or appointed officials, and ultimately to the consumers of their services. Similarly, the electric cooperatives which are NFP Energy End Users are directly accountable to their consumer-members and boards. Any gains or losses on an NFP Energy End User's energy transactions result in higher or lower energy costs to American businesses and consumers. The NFP Energy End Users do not seek profit for shareholders or investors. Their public service mission is the singular purpose and reason for their existence, and the interconnected Federal, state and local system of laws and financial regulation within which they operate is designed specifically to support this public service mission.

The markets for natural gas and power in North America are comprehensively regulated at the Federal, state and local level, with a focus on reliability of service and regulated rates payable by the retail customer. In addition, the natural gas and electric industries in North America (including the NFP Energy End Users) are subject to extensive environmental regulations and, in many states, renewable energy standards. Unlike other markets for over-the-counter ("OTC") derivatives and/or "swaps" (as newly defined by the Act), these are not unregulated markets. They are comprehensively regulated, and any new regulatory structure must be carefully tailored so as not to conflict or overlap with existing regulatory structures.

Some of the NFP Energy End Users' energy transactions are conducted through, "on," or "in" the "markets" operated by various regional transmission organizations or independent system operators (collectively, "RTOs"). RTOs operate their "markets" in certain defined geographic areas of the United States under a comprehensive regulatory structure established by the Federal Energy Regulatory Commission ("FERC"). The FERC-regulated markets are established by tariff in many instances, rather than by contract, and analogies between these FERC-created/FERC-regulated "markets," and the bilateral contract markets between independent and arm's length third parties, are inapt. Although in some ways, the markets conducted by the various RTOs are similar in structure, no two RTO markets are exactly alike and their "products" or "transactions" are not fungible between RTOs.

FERC's mandate from Congress under both the Federal Power Act and the Natural Gas Act is to regulate in the "public interest" -- which is interpreted as the delivery of reliable electric energy and natural gas to American consumers at "just and reasonable" rates. It is under this regulatory mandate that the RTOs (overseen by FERC) have established, and currently maintain and operate the FERC-regulated markets. The markets are intrinsically tied to the reliable physical transmission and ultimate delivery of electric energy in interstate commerce at just and reasonable rates.

All the energy contracts, agreements and transactions in which the NFP Energy End Users are engaged are currently conducted either on CFTC-regulated exchanges or under exemptions or exclusions from the Commodity Exchange Act (the "CEA"), whether conducted in the bilateral OTC contract market (as most are, including RTO transactions) or on exempt commercial markets. The participants in these markets are "eligible contract participants" either by virtue of their size and financial characteristics, or by virtue of their involvement in the underlying cash commodity markets relevant to their businesses (as "eligible commercial entities"). Other than a few large industrial companies, retail energy consumers generally do not participate in these wholesale markets directly. The physical and financial commodity transactions occur principal to principal, through agents and energy brokers, with a wide range of counterparties. As distinguished from other markets regulated by the CFTC, a significant percentage of these energy transactions do not involve financial intermediaries.

The transactions contain customized, non-quantitative operating conditions, transmission or transportation contingencies, and operating risk allocations that one would expect between commercial enterprises. Although some legal and administrative terms are standardized through the use of master agreements, the schedules to such master agreements and the individual transaction confirmations are highly negotiated and differ based on the needs and preferences of each pair of contract counterparties. These are commercial transactions when viewed through the traditional lens of "goods" and "services" used by American businesses. It is only when they are viewed through the financial markets lens (as the Act does) that these transactions are described using the financial market regulatory labels such as "exempt commodities," "swap agreements," "options," "swaps" or "nonfinancial commodities" -- and analogized to "futures contracts" or "positions" created or engaged in by financial entities on a transaction by

transaction basis for profit or speculation, and potentially subject to regulation traditionally applicable to such financial market professionals.

The NFP Energy End Users currently have the risk management choice to conduct some of these everyday transactions on CFTC-regulated contract markets, or to clear some of these transactions through CFTC-regulated centralized clearing entities. CFTC-regulated exchanges have only recently begun to list these types of contracts; and central clearing entities have only recently begun to clear energy transactions. Listed and cleared transactions are those delivered at “hubs,” in tradable increments and for tradable duration -- “swaps” that are “standardized” and “fungible” in financial market terms, and with sufficient trading liquidity to allow financial markets to function. As the CFTC-regulated financial markets have evolved, some of the larger NFP Energy End Users have chosen to manage certain of their commercial risks using exchange-traded and cleared instruments. But the vast majority of NFP Energy End Users’ commercial commodity transactions are still conducted “the old fashioned way”: under tariffs within the public power and cooperative systems or by contract with known and reliable suppliers and customers, and not with CFTC-regulated financial intermediaries or on exchanges or with clearing entities.

Due to the Act’s wholesale deletion of applicable exemptions in the CEA, and the potentially sweeping nature of the new definitions in the Act, these everyday transactions of the NFP Energy End Users are at some risk of being redefined as “swaps.” Although Congress has repeatedly indicated that its intention was NOT to reduce risk management options for end users or impose new costs on end users hedging the risks of traditional commercial enterprises, Congress is relying on the regulators to implement understandable rules consistent with that intent. Congress did not intend for the regulators to read the expansive language of the Act without regard to legislative intent, or to regulate and impose costs on end users as if they were professional financial market participants.<sup>4</sup>

## **II. COMMENTS**

### **A. *The CFTC Should Ensure that End Users are NOT Inadvertently Swept Up in the Definitions of “Swap Dealer” and “Major Swap Participant.”***

This issue was addressed in the EEI comment letter dated September 20, 2010 in response to the Definitions ANOPR (the “EEI Definitions ANOPR Comment Letter”), and we endorsed EEI’s comments in our NFP EEU Definitions ANOPR Comment Letter, filed the same day. A copy of the EEI Definitions ANOPR Comment Letter is attached hereto for your convenience, and you are referred to Section III thereof. In the NFP EEU Definitions ANOPR Comment Letter, you are referred to Sections II.B and II.C thereof.

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<sup>4</sup> See 156 Cong. Rec. H5248 (the “Dodd-Lincoln letter”).

B. *The CFTC Should Define “Commercial Risk” Broadly, and Interpret the Phrase Consistently Throughout the Commodity Exchange Act.*

Section 721(b) of the Act provides that the CFTC “may adopt a rule to define...the term ‘commercial risk.’” Our proposal for the definition of the statutory term “commercial risk” was addressed in our NFP EEU Definitions ANOPR Comment Letter in the context of the definition of “major swap participant.” You are referred to Section II.C thereof. That definition should also be used in the context of rule-makings for the end user exception.

The definition should accommodate the many and varied risks of a commercial enterprise (as juxtaposed with the risks faced by a financial entity), and which may be hedged or mitigated using swaps. The term is used to cover similar concepts in both these contexts and in other places in the Act where the defined term is used. Moreover, it is a fundamental principle of statutory construction that when a statute uses the same words in different sections of the same statute, those words should be interpreted to have the same meaning.<sup>5</sup>

C. *The CFTC Should Confirm that Eligible Commercial Entities are Eligible Contract Participants for Swaps where the Commodities Underlying Such Swaps Are Those Commodities In Which the Eligible Commercial Entity Transacts in the Conduct of its Commercial Enterprise, and Concurrently the CFTC Should Confirm and Determine that all NFP Energy End Users are Eligible Contract Participants.*

This issue was addressed in our NFP EEU Definitions ANOPR Comment Letter. You are referred to Section II.D.1 thereof. This issue becomes of even more importance to the NFP Energy End Users if it determines whether they can fully utilize the end user exception. See Section II.D below.

D. *The CFTC Should Interpret New CEA Section 2(e) Consistently with New CEA Sections 2(h)(7) and 2(h)(8).*

A non-financial entity eligible to use the “end user exception” to clearing in new Section 2(h)(7) of the CEA is also entitled to the correlated exception from transacting on exchange provided in new Section 2(h)(8). However, new CEA Section 2(e) could be read separately to require that some of these end user transactions take place only on a designated contract market, or make the off-exchange transactions unlawful -- if the end user does not meet the definition of Eligible Contract Participant (which is mentioned nowhere in Section 2(h)).

We believe that the lack of a cross-reference in Section 2(e) is a drafting error in the Act. It cannot have been Congress’ intent to grant the end user exception and correlated exception from exchange trading, and yet “catch” certain NFP Energy End Users with new Section 2(e), and force them to transact only in the quantities and at delivery locations which may be listed on

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<sup>5</sup> Powerex Corp. v. Reliant Energy Services, 551 U.S. 224 (2007) (“A standard principle of statutory construction provides that identical words and phrases within the same statute should normally be given the same meaning.”).

designated contract markets, in order to hedge their commercial risks. In such a case, CEA Section 2(e) would effectively deny the end user exception to a non-Eligible Contract Participant, since the end user would have to incur the transaction and financial intermediary costs, including margin, to transact on exchange, or forego hedging its commercial risks.

Confirmation of this interpretation in the CFTC's rulemakings is crucial for entities such as small NFP Energy End Users, that *should* qualify as Eligible Contract Participants for those commodities in which they transact their commercial enterprise, but may not meet the financial parameters otherwise set forth in the definition of Eligible Contract Participant --see Section II.C above. The NFP Energy End Users anticipate that they will utilize the end user exceptions from clearing and exchange-trading for most of the swaps where the underlying commodities are those in which they conduct commercial activities -- to allow them to hedge their commercial risks efficiently and cost-effectively, using the customized terms and credit support mechanisms found only in the non-cleared markets. Congress clearly intended the end user exception to be available to all non-financial entities hedging commercial risk.

For example, a small municipal electric utility may want to hedge its production/purchased power costs by fixing the price of forward power that it needs to serve its load in July and August 2012. Its load and weather forecasts for its service territory (compared with its owned and purchased power assets) indicate it will need 30-34 megawatts delivered to its service territory for each of those forward months. Or, suppose a small municipal gas utility wants to fix the price of natural gas it expects to need to serve its load in November 2012 through March 2013 (based on load, weather and its gas assets) by purchasing a fixed for floating price swap for 50,000 MMBtus (5 futures contract equivalents) per month. Or, perhaps an electric cooperative wants to sell into the market the excess generation from a 200 megawatt plant that it completed in 2010 (based on pre-recession load growth forecasts) and use the sale proceeds to reduce debt incurred to build such generation over the next 3 years, while retaining access to the forward power to serve its projected long term load growth after 2014. The cooperative in this scenario wants to fix the forward price at which it will sell 145, 120 and 75 MWs forward for the next 3 years to "lock in" the power sales price it will receive and then use to reduce its debt load. In each of these examples, the small NFP Energy End User would utilize the end user exception to engage in a non-cleared, off-exchange swap to protect its costs against potentially intolerable price changes. The swap would be customized to hedge as precisely as possible the unique commercial risk the NFP Energy End User needs to hedge. However the NFP Energy End User in each example may or may not meet the financial tests within the definition of Eligible Contract Participant.

The NFP Energy End Users transact in the energy and energy-related commodity and swaps market solely to protect their enterprise cost structure from potential price fluctuations, unlike commodity and swap traders who initiate positions and then offset those transactions seeking to profit from market price movements. Every NFP Energy End User seeking to hedge its commercial risk in this way needs to be able to assure itself and its counterparty that Section 2(e) will not make the swap unlawful. For this reason, the NFP Energy End Users request that the CFTC confirm that its interpretation that new Section 2(e) is intended to be applicable except

to transactions entered into in reliance on the end user exceptions in new Sections 2(h)(7) and 2(h)(8).

E. *For End Users, the Required Notification of “How It Generally Meets Financial Obligations for Non-Cleared Swaps” Should be a One-Time Representation About Risk Management Policies, with an Obligation to Update If Its Representation Requires Updating, Revision or Clarification for Any Reason.*

The CFTC’s requirements for end user notifications under Section 2(h)(7)(A)(iii) of the CEA should be reasonable and streamlined. This section of the Act allows the CFTC to specify the ways in which an end user may satisfy the statutory requirement that the end user notify the CFTC of “how it *generally* meets its financial obligations for non-cleared swaps (*emphasis added*).” The statutory requirement does not provide any analysis or insight into the varied ways in which end users might use swaps to manage commercial risk and, in that context, “generally” meet their associated financial obligations. Nor does the statutory requirement take into account or relate the notification to any systemic risk to the financial markets that the end user’s non-cleared swaps might represent (or, more to the point, do not represent). So the CFTC needs to take a common sense approach, minimizing filing requirements and keeping in mind the wide variety of ways in which end users hedge their idiosyncratic commercial risks.

End users engage in swaps to hedge or mitigate the commercial risks that arise naturally and inevitably in their commercial enterprises. Those commercial risks are identifiable (for each commercial enterprise), and each management team then chooses to either mitigate or manage such risks or to allow the commercial risks to remain “unhedged” – which is, in itself, a passive method of risk management.

For the NFP Energy End Users, the commercial risks they face in their public service enterprises arise from the “natural short” position in which they usually find themselves. The NFP Energy End Users are load serving entities for the essential services -- natural gas or power -- necessary to run American homes and businesses. The NFP Energy End Users have continuing and absolute public service obligations to serve energy loads within their service territories. Unless and until the price and supply of the required volumes are acquired, the NFP Energy End Users are “short” and exposed to market price, availability and other commercial risks associated with their public service obligations. Accordingly, the sole purpose of the NFP Energy End Users to transact in the forward commodity and swaps markets is to mitigate those commercial risks. The NFP Energy End Users are clearly identifiable in the marketplace for energy and energy-related swaps as “natural shorts” (load serving entities in geographic service territories), and as entities for which it is politically and practically untenable at the time of delivery to be actually “short” of the deliverable energy commodity. As the delivery month approaches, the NFP Energy End Users and other load serving entities in the marketplace become more and more dependent on their risk management and energy procurement abilities to fill any gaps in their energy supply portfolios.

For NFP Energy End Users, hedging is not just about managing price risk. It is about fulfilling their public service mission (see Section I.E. above). The NFP Energy End Users hedge their physical need for power or natural gas with either purchased, options to purchase or

owned supply resources (as the offsetting “long positions”), and hedge the price and other commercial risks associated with those energy supply needs using forward contracts, options, swaps, and in some cases futures and exchange-traded options.

The NFP Energy End Users engage in swaps ONLY to hedge commercial risks. They do not speculate<sup>6</sup> and have no separate shareholder or investor base that would “profit” from such speculation. The NFP Energy End Users’ risk management policies and procedures typically prohibit speculation and prohibit engaging in swaps which are not of the class, category or type of swaps necessary to hedge their commercial risks. The NFP Energy End Users’ governing bodies (such as elected or appointed utility boards or electric cooperative boards, city councils, etc.), the regulators and the cooperative members --all comprised of citizens for whom the NFP Energy End Users provide essential services -- monitor those risk management policies and procedures carefully. As described in Section I.E. above, if a “loss” occurs in connection with the NFP Energy End User’s energy or energy-related swaps transactions, that loss will either indirectly or directly affect the energy costs of the American consumers served by that NFP Energy End User.

The NFP Energy End Users “meet their financial obligations for non-cleared swaps” in two ways. First and foremost, they maintain experience-tested risk management policies and procedures which prohibit speculation and which are appropriate to the extent and complexity of the NFP Energy End User’s involvement in the types of non-cleared swaps used to mitigate the commercial risks in the enterprise. These policies do not permit the entity to engage in swaps of other categories, classes or types deemed inappropriate to manage the entity’s commercial risks. In this regard, NFP Energy End Users are similar to other end users of commodity-based swaps. Their policies are not broad financial authorizations to transact in swaps and other financial products generally and for profit, at the discretion of the entity’s traders. Rather, they are focused policies, tailored to each entity’s specific hedging and commercial risk mitigation objectives.

The second way in which the NFP Energy End Users meet their financial obligations is that they have the measurable and identifiable commercial risks which can be managed or mitigated by use of swaps. But this concept is already inherent in the definition of “commercial risk” which underlies the end user exception. A further requirement for some other statement, representation or filing to the CFTC is superfluous. Only a market participant that “buys” or “sells” a swap position for the purpose of profit, rather than to hedge an existing commercial risk, increases systemic risk by entering into that non-cleared swap. An end user hedging commercial risk reduces risk, and “generally meets its financial obligations” in respect of that

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<sup>6</sup> The term “speculate” as used herein means deliberately taking a position, and then offsetting it with another position, for the purpose of profiting from favorable movements in market prices. Speculation is a risk-increasing activity in which commodity traders commonly engage. An NFP Energy End User may enter into a swap transaction that settles favorably (i.e., “in the money”). But that favorably-settling swap transaction offsets a correlated unfavorable movement/settlement in the commercial risk being hedged.

non-cleared swap when that swap settles by offsetting against the commercial risk that was hedged.

Ultimately, an NFP Energy End User meets its financial obligations in respect of the non-cleared hedges when customers in its service territory pay for the energy the NFP Energy End User delivers to them. If the CFTC requires any notification beyond the general risk management statement described above, it should be a similarly general statement that the NFP Energy End User has the ability, subject in some cases to review by state rate regulators or to other governmental or end user membership approvals, to adjust the rates payable by its customers for the commodity that the NFP Energy End User delivers to those customers.

The Coalition urges the CFTC to include in its rulemaking a provision allowing the CFTC notification for end users required by new Section 2(h)(7)(A)(iii) of the CEA to be limited to a one-time representation, with additional notification required only if that representation needs to be updated, revised or clarified in the future. The end user's representation may include an identification of the class, category or type of swaps in which the entity's risk management policies allow it to engage, and should be a general statement about the entity's management having made a determination that the risk management policies and procedures in place are appropriate to the scope and complexity of the entity's use of non-cleared swaps to hedge commercial risks.

We urge the CFTC not to require specific language in the representation or certain risk metrics, and not to require periodic financial statement filings or financial metrics. The CFTC rules should be principles-based. As discussed in Section I.E. above, the scope and complexity of the NFP Energy End Users' risk management policies and procedures vary considerably, just as the size and complexity of the NFP Energy End Users' service territories, energy resources and operations vary.<sup>7</sup> It is not the absolute size or financial underpinnings of the entity, but the appropriateness of its risk management policies and procedures that provides an end user with the ability to safely manage its commercial risks and generally meet its financial obligations for non-cleared swaps.

This type of one time notification will meet the requirements of Section 2(h)(7)(A)(iii) without placing unnecessary regulatory burdens on NFP Energy End Users, allowing them to focus instead on smooth integration of the new CFTC regulatory structure into their already comprehensive and time-tested risk management procedures. Additionally, the NFP Energy End Users respectfully request that a SBREFA review be conducted, focused on any regulatory notice

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<sup>7</sup> To give the Task Force some examples of the diversity of assets, load (customers served within the utility's geographic service territory), energy hedging and risk management policies, swap usage and collateral/margin experience within the NFP EEU membership, we have attached eight "profiles" of individual NFP Energy End Users. None of these profiles purport to be "typical" of large, medium or small NFP Energy End Users (by number of customers). No NFP Energy End User is typical, given their diverse commercial profiles. However, the CFTC's regulations have to work for all NFP Energy End Users who share the identical public service mission.

requirements to be imposed on end users that are “small entities,” with full opportunity for input and public hearing.

F. *For compliance with the CEA and all regulations promulgated thereunder, transactions between members of a “Related NFP EEU Group” should be disregarded.*

Some electric cooperatives which provide electric service to their members/consumers, and some municipal or other governmental entities providing natural gas or electric utility services to their constituents, are also “members” (for cooperatives) or “participants” (for governmental entities) in larger NFP Energy End Users entities. For example, an electric “distribution cooperative” may also be a member of a “generation and transmission cooperative (G&T cooperative).” Or, a municipal gas or electric utility may also be a participant in a “joint action agency” or a “joint power authority.” These groups of related NFP Energy End Users (“Related NFP EEU Groups”) are **not** analogous to corporate affiliates, families of affiliated funds or limited partnerships, or other affiliated groups of independent for-profit entities.

A Related NFP EEU Group is not “under common control,” in that its members or participants are independent, and the larger, aggregated entity may have many members, none of which can exert “control” over the aggregated entity. For example, a G&T cooperative operates on the principle of “one member-one vote,” so that only a numeric majority of its members can, for any particular decision, control the G&T cooperative. In addition, the constituent entities of a Related NFP EEU Group are all not-for-profit, as is the aggregated entity that is owned or controlled collectively by the constituent entities. The Related NFP EEU Group therefore conducts business within the group on a collective service/shared mission basis, rather than at arms length. Although the structures are in some respect analogous to the agricultural cooperatives that the CFTC has dealt with in the past, the Related NFP EEU Groups differ in function from agricultural cooperatives. The Related NFP EEU Groups are generally “net short/purchasing cooperative entities,” rather than “net long/selling cooperative entities.” Their common purpose is not to access a market to sell their commodity, but to fulfill their shared public service commitment to deliver reliable, affordable natural gas and/or power to consumers in their service territories.

Under the government, membership and regulatory regimes that currently govern a Related NFP EEU Group’s activities (including state constitutions and statutes, the jurisdictional documents forming entities within the Related Groups, and other regulatory agencies with jurisdiction), entities within an identifiable Related NFP EEU Group are treated in many respects as “federated systems” of end users. Each Related NFP EEU Group acts collectively to build and operate electric generation and transmission assets, to purchase or sell natural gas and power, to collectively borrow money and manage their assets and to provide service to the consumers and businesses within their collective service territories. These Related NFP EEU Groups are all part of the NFP EEU system that has existed for 70+ years as a way of delivering energy to American consumers at just and reasonable rates. None of these Related NFP EEU Groups pose a systemic risk to the financial markets or the financial systems.

The transactions that take place between entities within a Related NFP EEU Group have little to no effect on the commodity or swap markets in which the NFP Energy End Users participate. Nor do the payments or accounting arrangements between members of a Related NFP EEU Group have any bearing on market pricing or transparency of market pricing. Substantially all of these intra-Group transactions are cost-based, and there is no independent third party investor or shareholder to “profit” from market-pricing. For this reason, transactions between members of a Related NFP EEU Group should be disregarded for CFTC record keeping and reporting purposes. Intra-Related NFP EEU Group transactions should not be subject to margining or any other aspect of CFTC jurisdiction. And if one entity within a Related NFP EEU Group acts for or on behalf of another entity within the same Related NFP EEU Group, that act should have no regulatory ramifications for either party. Only transactions with third parties outside of a Related NFP EEU Group should be considered as transactions potentially subject to the CFTC’s jurisdiction.<sup>8</sup>

### **III. CONCLUSION**

The Coalition strongly encourages the CFTC to consider the foregoing comments as the CFTC proceeds with its rule-makings. The NFP Energy End Users are quintessential “end users of energy and energy-related commodities and swaps.” The Coalition respectfully requests that the CFTC issue rules and clarifications that will preserve the NFP Energy End Users’ ability to hedge and mitigate commercial risks and that the CFTC not impose new and unnecessary regulatory burdens on end users.

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<sup>8</sup>Certain members of the NFP Energy End User Coalition – the public power utilities and the electric cooperatives -- anticipate filing a CEA Section 4(c) exemption request for transactions *between* entities defined in Section 201(f) of the Federal Power Act (“FPA 201(f) entities”) pursuant to new CEA Section 4(c)(6) (C), as amended by Section 722(f) of the Act. – that is, for electric energy transactions *between* FPA 201(f) entities which are not participants in the same Related NFP EEU Group.

David Stawick, Secretary  
November 22, 2010  
Signature Page

Respectfully yours,

**THE "NOT-FOR-PROFIT ENERGY END USER  
COALITION":**

**NATIONAL RURAL ELECTRIC  
COOPERATIVE ASSOCIATION**

By: Russ Wasson  
Russell Wasson  
Director, Tax, Finance and Accounting  
Policy

**AMERICAN PUBLIC POWER ASSOCIATION**

By: \_\_\_\_\_  
Susan N. Kelly  
Senior Vice President of Policy Analysis  
and General Counsel

**AMERICAN PUBLIC GAS ASSOCIATION**

By: \_\_\_\_\_  
Dave Schryver  
Executive Vice President

**LARGE PUBLIC POWER COUNCIL**

By: \_\_\_\_\_  
Name:  
Title:

cc: Honorable Gary Gensler, Chairman  
Honorable Michael Dunn, Commissioner  
Honorable Jill E. Sommers, Commissioner  
Honorable Bart Chilton, Commissioner  
Honorable Scott O'Malia, Commissioner

David Stawick, Secretary  
November 22, 2010  
Signature Page

Respectfully yours,

**THE "NOT-FOR-PROFIT ENERGY END USER  
COALITION":**

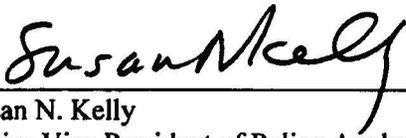
**NATIONAL RURAL ELECTRIC  
COOPERATIVE ASSOCIATION**

By: \_\_\_\_\_

Russell Wasson  
Director, Tax, Finance and Accounting  
Policy

**AMERICAN PUBLIC POWER ASSOCIATION**

By: \_\_\_\_\_

  
Susan N. Kelly  
Senior Vice President of Policy Analysis  
and General Counsel

**AMERICAN PUBLIC GAS ASSOCIATION**

By: \_\_\_\_\_

Dave Schryver  
Executive Vice President

**LARGE PUBLIC POWER COUNCIL**

By: \_\_\_\_\_

Name:  
Title:

cc: Honorable Gary Gensler, Chairman  
Honorable Michael Dunn, Commissioner  
Honorable Jill E. Sommers, Commissioner  
Honorable Bart Chilton, Commissioner  
Honorable Scott O'Malia, Commissioner

David Stawick, Secretary  
November 22, 2010  
Signature Page

Respectfully yours,

**THE "NOT-FOR-PROFIT ENERGY END USER  
COALITION":**

**NATIONAL RURAL ELECTRIC  
COOPERATIVE ASSOCIATION**

By: \_\_\_\_\_

Russell Wasson  
Director, Tax, Finance and Accounting  
Policy

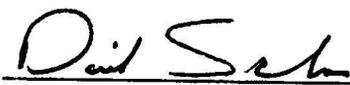
**AMERICAN PUBLIC POWER ASSOCIATION**

By: \_\_\_\_\_

Susan N. Kelly  
Senior Vice President of Policy Analysis  
and General Counsel

**AMERICAN PUBLIC GAS ASSOCIATION**

By: \_\_\_\_\_

  
Dave Schryver  
Executive Vice President

**LARGE PUBLIC POWER COUNCIL**

By: \_\_\_\_\_

Name:  
Title:

cc: Honorable Gary Gensler, Chairman  
Honorable Michael Dunn, Commissioner  
Honorable Jill E. Sommers, Commissioner  
Honorable Bart Chilton, Commissioner  
Honorable Scott O'Malia, Commissioner

David Stawick, Secretary  
November 22, 2010  
Signature Page

Respectfully yours,

**THE "NOT-FOR-PROFIT ENERGY END USER  
COALITION":**

**NATIONAL RURAL ELECTRIC  
COOPERATIVE ASSOCIATION**

By: \_\_\_\_\_  
Russell Wasson  
Director, Tax, Finance and Accounting  
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**AMERICAN PUBLIC POWER ASSOCIATION**

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Susan N. Kelly  
Senior Vice President of Policy Analysis  
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**AMERICAN PUBLIC GAS ASSOCIATION**

By: \_\_\_\_\_  
Dave Schryver  
Executive Vice President

**LARGE PUBLIC POWER COUNCIL**

By:   
Jorge Carrasco  
LPPC Chair

cc: Honorable Gary Gensler, Chairman  
Honorable Michael Dunn, Commissioner  
Honorable Jill E. Sommers, Commissioner  
Honorable Bart Chilton, Commissioner  
Honorable Scott O'Malia, Commissioner

**COMMENT LETTER OF THE COALITION DATED SEPTEMBER 20, 2010**

See Attached



September 20, 2010

David Stawick, Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington, D.C. 20581  
Email to [secretary@cftc.gov](mailto:secretary@cftc.gov), [dfdefinitions@cftc.gov](mailto:dfdefinitions@cftc.gov) and [otcdefinitions@cftc.gov](mailto:otcdefinitions@cftc.gov) with  
Definitions in Subject line;

**Re: Proposed Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act**

Dear Mr. Stawick:

The trade associations comprising the “Not-For-Profit Energy End User Coalition” (the “Coalition”) respectfully submit these comments to the Commodity Futures Trading Commission (the “CFTC”) in response to the Advanced Notice of Proposed Rulemaking entitled “Definitions contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act.”<sup>1</sup> This rulemaking is part of the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”). Given the nature of our members’ commercial businesses, our comments focus primarily on the aspects of the definitions that will affect end users of energy and energy-related commodities.<sup>2</sup>

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<sup>1</sup> 75 Fed. Reg. 51,429 (Aug. 20, 2010).

<sup>2</sup> The comments contained in this filing represent the initial comments and recommendations of the organizations comprising the “Coalition,” but not necessarily the views of any particular member with respect to any issue.

As the CFTC (along with the Securities and Exchange Commission and the prudential regulators) embarks on the complex and interrelated rule-makings necessary to implement the Act, the Coalition respectfully requests that the regulators keep in mind at each step along the way how these rule-makings will ultimately impact the commercial businesses that are “end users” of commodities and “swaps.” These are not financial entities, and they have not previously been regulated by the CFTC. Under current law, if an end user chooses to buy or sell CFTC-regulated futures contracts or options or to utilize a CFTC-regulated clearing entity to manage its commercial risk, this represents one commercial choice among many. In many circumstances, small businesses in particular choose to manage their risks in less expensive ways. On the day after the effective date of the Act, each of these end users will still have a business to run, commercial risks to manage and customers to serve. The Act was intended by Congress to regulate the financial markets more effectively, and to provide regulatory oversight to financial entities. The rule-makings must not leave commercial businesses uncertain as to which of their ongoing activities will now be regulated by the CFTC. Nor should the rule-makings impose on these businesses unnecessary regulatory costs and burdens.

## **I. THE COALITION MEMBERS<sup>3</sup>**

The Coalition is comprised of four trade associations representing the interests of not-for-profit, consumer-owned electric and gas utilities in the United States (collectively, the “NFP Energy End Users”). The primary business of these NFP Energy End Users has been for well over 75 years, and still is today, to provide reliable natural gas and/or electric energy to their retail consumer customers every hour of the day and every season of the year, keeping costs low and predictable, while practicing good environmental stewardship. The NFP Energy End Users are public service entities, owned by and accountable to the American consumers they serve.

### **A. NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION (“NRECA”)**

Formed in 1942, NRECA is the national service organization for more than 900 not-for-profit rural electric utilities and public power districts that provide electric energy to approximately 42 million consumers in 47 states or 12 percent of the nation’s population. Kilowatt-hour sales by rural electric cooperatives account for approximately 11 percent of all electric energy sold in the United States. NRECA members generate approximately 50 percent of the electric energy they sell and purchase the remaining 50 percent from non-NRECA members. The vast majority of NRECA members are not-for-profit, consumer-owned cooperatives which distribute electricity to consumers. NRECA’s members also include

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<sup>3</sup> The Coalition is grateful to the following organizations and associated entities who are active in the legislative and regulatory policy arena in support of the NFP Energy End Users, and who have provided considerable assistance and support in developing these comments. The Coalition is authorized to note their involvement to the CFTC, and to indicate their full support of these comments and recommendations: The Transmission Access Policy Study Group (an informal association of transmission dependent electric utilities located in more than 30 states), ACES Power Marketing and The Energy Authority.

approximately 66 generation and transmission (“G&T”) cooperatives, which generate and transmit power to 668 of the 846 distribution cooperatives. The G&T cooperatives are owned by the distribution cooperatives they serve. Remaining distribution cooperatives receive power directly from other generation sources within the electric utility sector. Both distribution and G&T cooperatives were formed to provide reliable electric service to their owner-members at the lowest reasonable cost. All these cooperatives work together pursuant to their common public service mandate from their members, often without the type of contracts that exist between for-profit entities. Rather, many cooperatives deal with each other under take and pay “all requirements contracts” which set forth the terms of service/energy sales, but not necessarily the price for such service/energy sales. For example, as between a G&T cooperative and its distribution cooperative owner-members, the price is often determined based on a “cost of service” rate, with no market price component.

Electric cooperatives own approximately 43% of the distribution lines in the U.S., reaching some of the country’s most sparsely populated areas, from Alaskan fishing villages to remote dairy farms in Vermont. In an electric cooperative, unlike most electric utilities, its owners -- called “members” of the cooperative -- are also customers, who are able to vote on policy decisions, directors and stand for election to the board of directors. Because its members are customers of the cooperative, all the costs of the cooperative are directly borne by its consumer-members.

The vast majority of NRECA’s members meet the definition of “small entities” under the Small Business Regulatory Enforcement Fairness Act (the “SBREFA”). Only four distribution cooperatives and approximately 28 G&Ts do not meet the definition. Regulatory Flexibility Act (RFA), 5 U.S.C. §§ 601-612 (as amended Mar. 29, 1996). The RFA incorporates by reference the definition of “small entity” adopted by the Small Business Administration (SBA). The SBA’s small business size regulations state that entities which provide electric services are “small entities” if they dispose of 4 million MWh or less per year. 13 C.F.R. §121.201, n.1.

#### B. AMERICAN PUBLIC POWER ASSOCIATION (“APPA”)

APPA is the national service organization representing the interests of publicly-owned electric utilities in the United States. More than 2,000 public power systems provide over 15 percent of all kilowatt-hour sales to ultimate customers and serve 45 million people. APPA’s member utilities are not-for-profit utility systems that were created by state or local governments to serve the public interest. These systems take various forms, including departments of a municipality; a utility board or a public utility district formed under state or local law; a joint action agency or joint power agency formed under state law to provide wholesale power supply and transmission service to distribution entity members; a state agency, authority or instrumentality; or other type of political subdivision of a state. Like the members of NRECA, the vast majority of APPA’s members are considered “small entities” under the RFA.

Public power utilities perform a variety of electric utility functions. Some generate, transmit, and sell power at wholesale and retail, while others purchase power and distribute it to retail customers, and still others perform all or a combination of these functions. All these

systems work together pursuant to their common statutory and regulatory mandates. Some are “vertically integrated” electric utilities (engaging in generation, transmission, distribution and retail sales), while others are vertically integrated by contract with other “201(f) entities” (entities that are exempt from full Federal Power Act rate regulation under Section 201(f) of that statute)<sup>4</sup>, or by contract with third parties.

Public power utilities are accountable to elected and/or appointed officials and, ultimately, the American public. The focus of a public power utility is to provide reliable, safe electricity service, keeping costs low and predictable for its customers, while practicing good environmental stewardship.

#### C. AMERICAN PUBLIC GAS ASSOCIATION (“APGA”)

The APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and over 720 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities. The purpose of a public gas system is to provide reliable, safe and affordable natural gas service to the community it serves. Public gas systems depend on the physical commodity markets, as well as financial market transactions, to meet the needs of their consumers. Together, these markets play a central role in public gas utilities securing natural gas supplies at reasonable and stable prices. Specifically, many public gas utilities purchase firm gas supplies in the physical delivery market at prevailing market prices, and enter into OTC derivatives customized to meet their specific needs to hedge their customers’ exposure to future market price fluctuations and stabilize rates. As with APPA-member systems, the APGA members work together pursuant to their common statutory and regulatory mandates, often without the types of contracts that exist between for-profit entities, but instead under tariff arrangements or all requirements contracts.

#### D. LARGE PUBLIC POWER COUNCIL (“LPPC”)

The Large Public Power Council is an organization representing 24 of the largest locally owned and operated public power systems in the nation. LPPC members own and operate over 75,000 megawatts of generation capacity and nearly 34,000 circuit miles of high voltage transmission lines. Collectively, LPPC members own nearly 90% of the transmission investment owned by non-federal public power entities in the U.S. Our member utilities supply power to some of the fastest growing urban and rural residential markets in the country. Members are located in 11 states and Puerto Rico -- and provide power to some of the largest cities in the country including Los Angeles, Seattle, Omaha, Phoenix, Sacramento, Jacksonville, San Antonio, Orlando and Austin. Members of the LPPC are also members of APPA.

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<sup>4</sup> For more discussion of 201(f) entities, see the comment in Section IIA3 below.

E. THE COALITION'S MEMBERS ARE UNIQUE, AS ARE THE "MARKETS" IN WHICH THEY TRANSACT, AND THE TRANSACTIONS IN WHICH THEY ENGAGE.

The NFP Energy End Users represented by the Coalition include public power entities, public gas entities and rural electric cooperatives. Some are quite large, but most of these NFP Energy End Users are very small, reflecting the communities they serve, the success of those communities in providing reliable essential services for their citizens at the lowest reasonable rates and, in the case of rural electric cooperatives, the contribution to Americans' quality of life of the Rural Electrification Act of 1936.

Some NFP Energy End Users generate, transmit and sell electric energy to their fellow public power systems and cooperatives at wholesale, while others purchase natural gas and/or electric energy, and distribute it to retail consumers. Still others perform all or a combination of these commercial functions. The Coalition's members are unique among "end users" whose transactions are potentially subject to CFTC regulation as "swaps" (even among those who are "end users" of energy and energy-related commodities and swaps) in that the public power and gas entities have no stockholders and are accountable to elected and/or appointed officials, and ultimately to the consumers of their services. Similarly, the electric cooperatives are directly accountable to their consumer-members and boards. The NFP Energy End Users' public service mission is the singular purpose and reason for their existence, and the interconnected Federal, state and local system of laws and financial regulation within which they operate is designed specifically to support this public service mission.

NFP Energy End Users have a different credit profile than your average "trader" or financial market participant. Due to their consumer-owned and public service nature, most do not have significant assets available to post as margin (due to statutory or government financing restrictions) or significant non-operating accounts, investments or lines of credit available to post "margin" for their long-term infrastructure transactions, especially in the volatile natural gas and power markets. In this way, the NFP Energy End Users are fundamentally different from other entities the CFTC regulates or is charged with regulating under its new jurisdiction.

The markets for natural gas and power in North America are comprehensively regulated at the Federal, state and local level, with a focus on reliability of service and regulated rates payable by the retail customer. In addition, the natural gas and electric industries in North America (including the NFP Energy End Users) are subject to extensive environmental regulations and, in many states, renewable energy standards. Unlike other markets for over-the-counter ("OTC") derivatives and/or "swaps" (as newly defined by the Act), these are not unregulated markets. They are comprehensively regulated, and any new regulatory structure must be carefully tailored so as not to conflict with existing regulatory structures.

A substantial number of the NFP Energy End Users manage the commodity and other commercial risks associated with their business by entering into "contracts, agreements and transactions" in energy and energy-related "exempt commodities," including, without limitation, transactions in electric power, natural gas and, in the case of electric utilities, other fuels for

generation. Other commercial risks are managed using options on natural gas, power or other exempt commodities, or “swap agreements.” Some of these transactions are conducted through, “on” or “in” the “markets” operated by regional transmission organization or independent system operator (collectively, “RTOs”). These markets operate in certain geographic areas of the United States under a comprehensive regulatory structure established by the Federal Energy Regulatory Commission (“FERC”). The FERC markets are established by tariff in many instances, rather than by contract, and analogies between this system and the bilateral contract markets between independent and arm’s length third parties are inapt.

FERC’s mandate from Congress under the Federal Power Act and the Natural Gas Act is to regulate in the “public interest” -- which is interpreted as delivering reliable electric energy and natural gas to American consumers at “just and reasonable” rates. It is under this regulatory mandate that the RTOs (overseen by FERC) have established, and currently maintain and operate the FERC-regulated markets. The markets are intrinsically tied to the reliable physical transmission and ultimate delivery of electric energy in interstate commerce at just and reasonable rates.

All these energy contracts, agreements and transactions are currently conducted under exemptions or exclusions from the Commodity Exchange Act (the “CEA”), whether conducted in the bilateral over-the-counter contract market (as most are) or on exempt commercial markets. The participants in these markets are “eligible contract participants” either by virtue of their size and financial strength, or by virtue of their involvement in the underlying cash commodity markets relevant to their businesses (as “eligible commercial entities”). Other than a few large industrial companies, retail energy consumers do not participate in these markets directly. The physical and financial commodity transactions occur principal to principal, through agents and energy brokers, with a wide range of counterparties. As distinguished from other markets regulated by the CFTC, many of these energy transactions do not involve financial intermediaries. The transactions contain customized, non-standardized operating conditions, transmission or transportation contingencies, and operating risk allocations that one would expect between commercial businesses. They are commercial transactions, when viewed through the traditional lens of “goods” and “services” used by American businesses. It is only when they are viewed (as the Act does) through the financial markets lens that they are characterized with the financial market regulatory labels such as “exempt commodities,” “swap agreements,” “options,” “swaps” or “nonfinancial commodities” -- and analogized to “futures contracts” or “positions” created by financial entities for profit or speculation, and potentially subject to regulation traditionally applicable to such financial market professionals.

The NFP Energy End Users currently have the risk management choice to conduct some of these everyday transactions on CFTC-regulated contract markets, or to clear the transactions through CFTC-regulated centralized clearing entities. But NFP Energy End Users make that choice relatively rarely. The exchanges have only recently begun to list a significant number of these types of contracts; and central clearing entities have only recently begun to clear energy transactions, especially those which are not standardized or “fungible” in financial market terms. Compared to markets for other commodities, natural gas, power and related transactions are

often highly customized, and contain longer terms as necessary for these infrastructure businesses, as necessary to serve retail customers, and significant operating conditions or contingencies, reflecting the inherent physical and commercial nature of the business. As the CFTC-regulated financial markets have evolved, some of the larger NFP Energy End Users have chosen to manage certain of their commercial risks using exchange-traded and cleared instruments. But the vast majority of NFP Energy End Users' commercial commodity transactions are still conducted "the old fashioned way": under tariffs within the public power and cooperative systems or by contract with known and reliable suppliers and customers, and not with CFTC-regulated financial intermediaries or on exchanges or clearing entities.

Due to the wholesale deletion of applicable exemptions in the CEA, and the potentially sweeping nature of the new definitions, these everyday business transactions of the NFP Energy End Users may suddenly, unexpectedly, be redefined as "swaps." Physical forward commodity transactions, commercial option transactions, and option-like aspects of ordinary course "full requirements" natural gas and electric energy transactions could be captured within the new regulatory paradigm. Although Congress has repeatedly indicated that its intention was NOT to capture commercial transactions or to impose new costs on end users hedging risks of traditional commercial businesses, Congress is relying on the regulators to implement that intent and write clear rules. Congress did not intend for the regulators to read the expansive language of the Act without regard to legislative intent, nor to regulate and impose costs on end users as if they were professional financial market participants.<sup>5</sup>

The NFP Energy End Users are relying on the CFTC to draft clear rules, to make clear how current interpretations, no action positions and precedent under the CEA should be read in light of the Act's new and different regulatory structure, and to conduct all necessary exemption proceedings prior to the effective date of the Act (and with appropriate regulatory transition periods thereafter). We stand ready to help the CFTC understand our businesses, our industry and our "markets." If the CFTC ignores the effect of the Act on end users, NFP Energy End Users will face a wall of regulatory uncertainty on the day the Act is effective. Such a result would be a classic example of the unintended and harmful consequences of sweeping legislation and regulation drafted without careful attention to the potential adverse impacts for industries outside the traditional financial markets that Congress intended to stabilize.

## **II. COMMENTS**

### **A. DEFINITION OF "SWAP"**

The Coalition agrees with the comments and recommendations made regarding the definition of "swap" by the Edison Electric Institute in its comment letter to the CFTC dated September 20, 2010. In addition:

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<sup>5</sup> See 156 Cong. Rec. H5248 (the "Dodd-Lincoln letter")

1. Definition of “nonfinancial commodity”

The Coalition respectfully requests that the CFTC define the term “nonfinancial commodity,” which is not otherwise defined in the CEA. Moreover, the Coalition requests that the CFTC identify in its regulations (subject to public notice and industry comment) each of the cash “commodities,” “nonfinancial commodities,” and “swaps” now being transacted in the natural gas and electric energy industries in North America. The NFP Energy End Users are not financial market professionals. They manage ongoing commercial businesses and provide an essential service to American consumers and businesses. They transact in commercial goods and services every day, and they hedge commercial risks using the identifiable economic tools available to them in the marketplace. NFP Energy End Users do not “create” new transaction types or financially engineer “contracts” or take and trade “positions” to make a profit. They should not have to ask, transaction by transaction, for a CFTC determination as to whether a commonplace commercial transaction falls under the new CFTC jurisdiction. The NFP Energy End Users need regulatory certainty in order to continue conducting their business as usual on the day after the Act’s effective date. The NFP Energy End Users should not have to engage in such transactions without being told, in advance, if the CFTC sees such a commercial transaction as a “commodity,” or a “swap,” or a “financial commodity” (as opposed to a nonfinancial commodity). The Coalition requests that the CFTC grant certainty to end users in the energy industry, by definitively stating in its rule-making which energy and energy-related products and services currently transacted in the marketplace are “commodities,” which are “swaps,” and which are “nonfinancial commodities.”

The Coalition proposes that the definition of “nonfinancial commodities” should include all products and services related to the production, generation, transmission, transportation, storage, delivery or regulation of natural gas or electric energy delivered to North American consumers by commercial businesses in any part of that commodity chain, including all fuels used to produce electric energy, and all services, transactions, allowances, credits, licenses or intangibles defined by an energy or environmental regulator. These types of transactions are used to hedge, mitigate or manage the commercial risks inherent in physical (nonfinancial) delivery of energy commodities, including natural gas and electric energy. “Nonfinancial commodities” should also include all energy and energy-related products and services sold pursuant to “tariffs” approved by Federal, state or local energy regulators, a regulatory process focused on reliability and rate regulated service -- concepts in many ways inconsistent with the concepts that underlie financial market regulation. Finally, “nonfinancial commodities” should also include all contracts, agreements and transactions related to transmission, transportation and storage of energy and energy-related commodities.<sup>6</sup>

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<sup>6</sup> We request that the CFTC clarify this point in the definition of “nonfinancial commodity,” which appears in the exclusions to the definition of “swap.” The ambiguity actually emanates from the CEA’s definition of “commodity,” where the word “services” appears. Services agreements in the energy industry, including transmission, transportation and

The NFP Energy End Users deserve clear guidance with respect to each type of energy transaction. Understanding which transactions fall under the new regulatory scheme will be critical to commercial decisions the NFP Energy End Users need to make now and continue to make on the day after the effective date. NFP Energy End Users cannot be expected to stop doing business, develop and submit a request to the CFTC for a rule-making or an exemption on each commercial transaction, and await the CFTC's decision. The energy industry deserves to know in advance, and as soon as possible, which transactions need to be cleared, which need to be transacted on exchanges or swap execution facilities, which need to be recorded for later reporting and in what form, which need to fit within regulatory compliance programs, and which need to be reported, when and to whom. Addressing these issues early in the CFTC regulatory rule-making process will allow NFP Energy End Users to understand the scope of changes that the Act will require to the way in which they conduct their businesses. It will also allow input from the other regulators who have authority over the NFP Energy End Users, their transactions and the energy markets they utilize.

## 2. Tariff Transactions -- Exemption Process

As part of the definition of "swap," the Coalition requests that the CFTC, in conjunction with FERC, the RTOs, the Texas Public Utilities Commission, the Electric Reliability Council of Texas ("ERCOT") and other government and quasi-government energy tariff regulators, articulate an industry-wide exemption process, filing procedures, timelines and other related matters for the "Tariff Transaction" exemption provided for in Section 722(f) of the Act (CEA section 4(c)(6)(A)(B)). Although this exemption is found in a different section of the Act from the definition of "swap," and it refers to the CEA Section 4(c) exemption process, it is unclear how the exemption process is intended to work for transactions which exist currently under tariffs and, in particular, under the RTO and ERCOT rules. There are hundreds, if not thousands, of such tariff transactions, and all electric utility industry participants, including NFP Energy End Users, doing business in the applicable geographic regions use them every day. It is burdensome and unreasonable to expect individual market participants who utilize RTO products and services to request individual 4(c) transaction exemptions, or even product-by-product exemptions from the CFTC. The CFTC should initiate a process similar to the process outlined in the Act for currently cleared "swaps." Good public policy requires a timely, orderly and comprehensive process for exempting already-regulated transactions from duplicative regulation.

Moreover, the industry-wide exemption process should take place well before the effective date of the Act, and should include input from the regulators who approved the tariffs, as well as industry-wide input and public hearings on any transactions for which the CFTC does NOT intend to grant an exemption. The public interest invoked in Section 722(f) of the Act echoes the "public interest" mission of FERC described in Section IE above -- the public interest in reliable natural gas and power, delivered to the American public at just and reasonable rates. The NFP Energy End Users will continue to need to engage in tariff transactions the day after the

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storage contracts, are commercial transactions which should in almost all circumstances be excluded from the CFTC's jurisdiction under the CEA's forward contract exclusion(s).

Act's effective date in order to deliver energy to their customers. They cannot be left to wonder if these products will be deemed "swaps" by the CFTC on that effective date or retroactively at some later date.<sup>7</sup> After the effective date, there should be a clear and expeditious process whereby such exemptions will be filed by the entity or regulator authorized to approve the tariff, and promptly acted upon by the CFTC, to enable the tariff energy markets to continue to function with a focus on the public interest in delivering reliable and affordable energy delivered to the American consumer.

### 3. FPA 201(f) Transactions -- Exemption Process

The Coalition requests that the CFTC grant a blanket exemption from all aspects of the Act for all transactions between entities exempted from FERC regulation under Section 201(f) of the Federal Power Act.<sup>8</sup> These transactions are between entities in the public power and cooperative community, with no possibility of or incentive for profit at the counterparty's expense. They facilitate the public power system's, or the electric cooperative system's, public service mission, and have been generally exempt from most aspects of FERC jurisdiction for decades on the express understanding and regulatory determination that they are critical to the delivery of power to the American consumer, and do not represent an opportunity to profit to the detriment of either the counterparty or the ultimate consumer. These transactions are clearly distinguishable from transactions between independent arm's length for-profit parties.

#### B. DEFINITION OF "SWAP DEALER"

The Coalition agrees with the comments and recommendations made regarding the definition of "swap dealer" by the Edison Electric Institute in its letter to the CFTC dated September 20, 2010.

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<sup>7</sup> To be clear, the NFP Energy End Users believe such transactions should NOT be considered "swaps," as this would introduce burdensome, costly, duplicative and potentially conflicting regulation.

<sup>8</sup> FPA Section 201(f) can be found at 16 U.S.C. § 824, and states as follows:

**(f) United States, State, political subdivision of a State, or agency or instrumentality thereof exempt.** No provision in this subchapter shall apply to, or be deemed to include, the United States, a State or any political subdivision of a State, an electric cooperative that receives financing under the Rural Electrification Act of 1936 (7 U.S.C. 901 et seq.) or that sells less than 4,000,000 megawatt hours of electricity per year, or any agency, authority, or instrumentality of any one or more of the foregoing, or any corporation which is wholly owned, directly or indirectly, by any one or more of the foregoing, or any officer, agent, or employee of any of the foregoing acting as such in the course of his official duty, unless such provision makes specific reference thereto.

### C. DEFINITION OF “MAJOR SWAP PARTICIPANT”

The Coalition agrees with the comments and recommendations made regarding the definition of “major swap participant” by the Edison Electric Institute in its letter to the CFTC dated September 20, 2010. We agree with EEI’s request that the CFTC define the term “commercial risk” for purposes of the definition of “major swap participant” and for consistent use throughout the CEA, as amended by the Act. We recommend the following definition:

( ) **Commercial Risk.** This term means any risk that a person or governmental entity incurs, or anticipates incurring, in connection with operating a commercial business as distinguished from a financial entity, including, but not limited to: commodity risk; market risk, credit risk; operating risk; transportation and storage risk; liquidity risk; financial statement risk; regulatory risk; and any other risk that can be hedged or mitigated with a swap. Hedging and mitigating commercial risk does not include any activity undertaken to assume the risk of changes in the value of a commodity.

### D. DEFINITION OF “ELIGIBLE CONTRACT PARTICIPANT”

1. “Eligible Contract Participants” that are also “Eligible Commercial Entities”

Under the changes to the CEA effected by the Act, it is unlawful for any person who is not an eligible contract participant (“ECP”) to enter into a swap, unless the swap is entered into on a designated contract market. The NFP Energy End Users are public power and public gas entities, or electric cooperatives, that operate electric energy or natural gas utility businesses. They currently engage in contracts, agreements and transactions in energy and energy related “exempt commodities,” which may or may not be determined to be “swaps” under the Act’s sweeping definition. The NFP Energy End Users engage in such transactions in the course of their everyday commercial businesses to fulfill their obligation to deliver energy to retail consumers and to hedge, mitigate or manage commercial risk. It would not be cost-effective to conduct all their hedging transactions on an exchange. But some of these NFP Energy End Users do not meet the financial hurdles established in the definition of ECP due to their status as electric cooperatives or public power or gas entities. See the third paragraph of Section IE above. Accordingly, it is important that the CFTC confirm that such commercial entities qualify as ECPs, so that they can continue to engage in transactions which may be “swaps” under the Act, without transacting on an exchange. The NFP Energy End Users and other commercial entities will also need to be able to confirm the CFTC’s interpretation to their counterparties and prospective counterparties.

For electric cooperatives, the relevant portion of the definition of “eligible contract participant” is found in clause (v) of Section 1a(18) of the CEA, which reads as follows:

(v) A corporation, partnership, proprietorship, organization, trust or other entity

(I) That has total assets exceeding \$10,000,000;

(II) The obligations of which under an agreement, contract, or transaction are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by an entity described in subclause (I), in clause (i), (ii), (iii), (iv), or (vii), or in subparagraph (C); or

(III) That --

(aa) Has a net worth exceeding \$1,000,000; and

(bb) Enters into an agreement, contract, or transaction in connection with the conduct of the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business; (Emphasis added)

Under this definition, an electric cooperative can qualify as an ECP if it has \$1,000,000 net worth and engages in transactions to manage commercial risk. But some of the smallest NFP Energy End Users may not meet the financial test due to their status as a consumer-member owned entity. But such a small electric cooperative would meet the definition of “eligible commercial entity” (“ECE”) but for the requirement that an ECE must also be an ECP. See below. Accordingly, we request that the CFTC interpret the definition of ECP so as to include electric cooperatives that satisfy any one of the criteria in clauses (i), (ii) or (iii) of Section 1a(17)(A) of the CEA.

For governmental entities who engage in the delivery of natural gas and/or power, the relevant portion of the definition of “eligible contract participant” is found in clause (vii) of Section 1a(18) of the CEA, which reads as follows:

(vii) (I) a governmental entity (including the United States, a State, or a foreign government) or political subdivision of a governmental entity; (II) a multinational or supranational government entity; or (III) an instrumentality, agency, or department of an entity described in subclause (I) or (II);

except that such term does not include an entity, instrumentality, agency, or department referred to in subclause (I) or (III) of this clause unless (aa) the entity, instrumentality, agency, or department is a person described in clause (i), (ii), or (iii) of

paragraph (17)(A)<sup>9</sup>; (bb) the entity, instrumentality, agency, or department owns and invests on a discretionary basis \$50,000,000 or more in investments; or (cc) the agreement, contract, or transaction is offered by, and entered into with, an entity that is listed in any of subclauses (I) through (VI) of section 2(c)(2)(B)(ii). *(Emphasis added)*

Under this definition, a public power or gas entity can qualify as an ECP if it qualifies as an ECE under Section 1a(17)(A)(i), (ii) or (iii).<sup>10</sup>

Each of the criteria in Section 1A(17)(A)(i), (ii) and (iii) is independent of the others, and a public power and/or gas entity can qualify as an ECE, and therefore an ECP, if it meets any one of them. We believe that a public power or gas entity that distributes electric energy or natural gas to the public at retail as its commercial business clearly meets the criteria found in Section 1a(17)(A)(i)-(iii) of the CEA in that it “has a demonstrable ability, directly or through separate contractual arrangements, to make or take delivery of the underlying commodity,” and/or it “incurs risks, in addition to price risks, related to the commodity.”

Finally, in clause (C) of the definition of ECP, the CFTC is given the authority to determine that any other person may be an ECP “in light of the financial or other qualifications of the person.”

We respectfully request the CFTC to confirm that a public power or gas entity that meets one or more of the criteria set forth in Section 1a(17)(A)(i)-(iii) automatically qualifies as an ECP, regardless of its size or the value of assets that it owns or invests on a discretionary basis. In addition, we respectfully request that the CFTC determine, as permitted by Section 1a(18)(C) of the CEA, that an electric cooperative that enters into a transaction to hedge, mitigate or

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<sup>9</sup> See definition of “eligible commercial entity,” below.

<sup>10</sup> The relevant section defining an “exempt commercial entity” reads as follows:

“The term ‘eligible commercial entity’ means, with respect to an agreement, contract or transaction in a commodity -- (A) an eligible contract participant described in clause . . . (v)[electric cooperative] . . . or (vii)[public power and/or gas entity] . . . of paragraph (18)(A) that, in connection with its business --

- (i) has a demonstrable ability, directly or through separate contractual arrangements, to make or take delivery of the underlying commodity;
- (ii) incurs risks, in addition to price risk, related to the commodity; or
- (iii) [not relevant to NFP Energy End Users].” *(Emphasis added)*

manage commercial risk associated with its business and meets one or more of the criteria set forth in Section 1a(17)(A)(i)-(iii) automatically qualifies as an ECP regardless of its net worth.

2. Related Comments Regarding Treatment of “Special Entities”

Although the CFTC has not, at this time, sought comments on the definition of “Special Entity,” due to the interrelationship of this definition with the definition of “eligible contract participant,” we submit these comments here and plan also to submit them to the CFTC’s Task Force charged with Regulation of Swap Dealers and Major Swap Participants. The NFP Energy End Users must rely on the CFTC’s staff to be mindful of the interrelationship of all of the regulations. We understand the complexity of the CFTC staff’s challenge under the tight statutory timeframe for rule-makings. But the complexity of the provisions of the Act, and the lack of clarity as to how the various sections were meant to work both together and with the CEA as in effect prior to the Act, creates a challenge for NFP Energy End Users who are struggling to understand whether, how and why this new regulatory scheme will apply to their commercial businesses.

The term “special entity” is defined in the Act to include, among other entities, a State, State agency, city, county, municipality, or other political subdivision of a State. The Act imposes new duties on swap dealers and major swap participants in their dealings with special entities.

The Coalition believes that it is not necessarily an advantage to be treated as a special entity. To the extent that swap dealers or major swap participants face higher costs when dealing with special entities, they may choose not to deal with special entities for certain types of transactions, or they may increase the fees that they (directly or indirectly) charge special entities for engaging in swap transactions. We believe that an entity that is both an ECP and a special entity should be able to “opt out” of the protections afforded by whatever duties the CFTC may establish for swap dealers and major swap participants in their dealings with special entities. This approach is consistent with the traditional CEA use of the ECP definition, which identifies an ECP by financial strength and permits the ECP to act for itself in the exempt markets. It is also consistent with other provisions of the Act in which ECPs are allowed to engage in certain types of transactions that retail customers or smaller entities are not. This proposal would also be consistent with the ability that end users have to opt out of mandatory clearing for their swap transactions.

If the CFTC does not accept our recommendation that all ECPs should be able to opt out of being treated as a special entity, then at the very least an eligible commercial entity should not be treated as a special entity with respect to transactions in the commodities in respect of which the eligible commercial entity operates a commercial business. For example, a public gas or power entity that operates commercial businesses distributing natural gas and/or electric energy to retail consumers would potentially be both an eligible commercial entity (and so an ECP) and a special entity as those terms are defined under the CEA, as amended by the Act. In our view, the very fact that the public power entity is engaged in a commercial business activity involving the distribution of natural gas or electric energy means that it is not appropriate to treat the public

power entity as a special entity with respect to swap transactions intrinsically related to its commercial energy activities. Being treated as a special entity would most likely make it more difficult (and certainly more expensive) for the public power or natural gas entity to engage in the types of hedging transactions it needs in order to protect against the risks associated with its commercial activities.

### **III. CONCLUSION**

The Coalition strongly encourages the CFTC and the SEC to consider the effect on end users of “swaps” at every step of the regulatory rulemaking process. We respectfully request that, as the CFTC drafts its rules, it carefully consider the consequences to those who operate commercial businesses and are drawn into this new regulatory environment only because of the broad statutory language which could be read to redefine traditional commercial contracts as “swaps.” All of the NFP Energy End Users’ natural gas, electric energy and energy-related transactions are intrinsically tied to the physical commodities they deliver to American businesses and consumers -- there is no speculation and, given the NFP Energy End Users’ not-for-profit public service business, they have no incentive to speculate. NFP Energy End Users transact only to obtain and deliver energy to retail consumers and to manage commercial risks, so that the ultimate cost of reliable natural gas and electric energy to consumers is as low and predictable as possible, consistent with their environmental stewardship standards. Any new regulatory burdens, direct or indirect costs or requirements will result, dollar for dollar, in higher costs to the NFP Energy End Users’ customers and owners -- approximately 87 million (electric) and 5 million (gas) American retail consumers of electric energy and natural gas.

The NFP Energy End Users do not pose a threat to the United States banking or financial system. It was not Congress’ intent that the Act should impose regulatory burdens on commercial business by treating them like the financial market professionals who participate voluntarily in CFTC-regulated markets. Regulatory policy-making and rule-making must be tailored to achieve Congressional objectives without creating uncertainty as to who will be regulated and what transactions will be regulated once the effective date for the Act arrives. The rules should be tailored to fit the differing market structures, and to exclude, exempt or treat appropriately, the business entities that engage in commercial transactions which might be determined to fall within the Act’s sweeping new definitions.

If the CFTC decides not to clarify whether its regulations under the Act extend to commercial transactions that electric cooperatives and public power and gas systems utilize in their everyday business, the NFP Energy End Users respectfully request that an analysis be performed (pursuant to rule-making and with an opportunity for public hearing) on the potential impact of such regulations on “small entities” under the Regulatory Fairness Act, as noted above, to determine whether less burdensome alternative forms of regulation can be developed for small entities.

David Stawick, Secretary  
September 20, 2010  
Signature Page

Respectfully yours,

**THE "NOT-FOR-PROFIT ENERGY END USER  
COALITION"**

NATIONAL RURAL ELECTRIC  
COOPERATIVE ASSOCIATION

By:   
\_\_\_\_\_  
Russell Wasson  
Director, Tax, Finance and  
Accounting Policy

AMERICAN PUBLIC POWER  
ASSOCIATION

By: \_\_\_\_\_  
Susan N. Kelly  
Senior Vice President of Policy Analysis  
and General Counsel

AMERICAN PUBLIC GAS ASSOCIATION

By: \_\_\_\_\_  
Dave Schryver  
Executive Vice President

LARGE PUBLIC POWER COUNCIL

By: \_\_\_\_\_  
Name: \_\_\_\_\_  
Its: \_\_\_\_\_

cc: Honorable Gary Gensler, Chairman  
Honorable Michael Dunn, Commissioner  
Honorable Jill E. Sommers, Commissioner

David Stawick, Secretary  
September 20, 2010  
Signature Page

Respectfully yours,

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Senior Vice President of Policy Analysis  
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By: \_\_\_\_\_  
Name: \_\_\_\_\_  
Its: \_\_\_\_\_

cc: Honorable Gary Gensler, Chairman  
Honorable Michael Dunn, Commissioner  
Honorable Jill E. Sommers, Commissioner

David Stawick, Secretary  
September 20, 2010  
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Dave Schryver  
Executive Vice President

LARGE PUBLIC POWER COUNCIL

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Name: \_\_\_\_\_  
Its: \_\_\_\_\_

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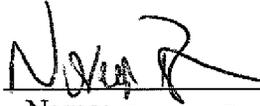
AMERICAN PUBLIC POWER  
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Dave Schryver  
Executive Vice President

LARGE PUBLIC POWER COUNCIL

By:  \_\_\_\_\_  
Name: Noreen Roche-Carter  
Its: Chair, LPPC Tax and  
Finance Task Force

cc: Honorable Gary Gensler, Chairman  
Honorable Michael Dunn, Commissioner  
Honorable Jill E. Sommers, Commissioner

David Stawick, Secretary

September 20, 2010

Signature Page

Honorable Bart Chilton, Commissioner

Honorable Scott O'Malia, Commissioner

Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (File Number  
S7-12-10 or S7-16-10 (unclear in the Federal Register Notice) – filed by e-mail  
per Federal Register Notice

**EEI DEFINITIONS ANOPR COMMENT LETTER**

See Attached

September 20, 2010

**VIA E-MAIL: [dfdefinitions@cftc.gov](mailto:dfdefinitions@cftc.gov)**David A. Stawick  
Secretary  
Commodity Futures Trading Commission  
1155 21st Street, N.W.  
Washington, DC 20581**Re: Definitions Contained in Title VII of Dodd-Frank Wall Street Reform  
and Consumer Protection Act, 75 Fed. Reg. 51429 (August 20, 2010)**

Dear Mr. Stawick:

The Edison Electric Institute (“EEI”) respectfully submits these comments in response to the Commodity Futures Trading Commission’s (“Commission” or “CFTC”) and Securities and Exchange Commission’s August 20, 2010, Advance Notice of Proposed Rulemaking (the “Advance Notice”) regarding key definitions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).<sup>1</sup>

As the agencies begin the process of implementing the Dodd-Frank Act through an unprecedented series of complex and interrelated rulemakings, EEI appreciates the opportunity to provide the CFTC in particular with its views on the impact that certain key definitions, including the definitions of “swap,” “swap dealer,” and “major swap participant,” potentially will have on the business operations of physical energy companies and other commercial end users of commodity swaps. Because EEI’s members use, process, produce and market energy commodities, our comments focus primarily on the commodity-related aspects of the key definitions. EEI respectfully requests that the Commission define these key terms in a manner that, consistent with Congress’s intent, exempts end users and their hedging transactions from additional regulatory requirements that could materially increase the costs that they and their customers will incur.

**I. Description of EEI and its Interest in the Advance Notice**

EEI is the association of U.S. shareholder-owned electric companies. EEI’s members serve 95 percent of the ultimate customers in the shareholder-owned segment of the U.S. electricity industry, and represent approximately 70 percent of the U.S. electric power industry.

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<sup>1</sup> Pub. L. No. 111-203 (2010) (to be codified as an amendment to the Commodity Exchange Act in scattered sections of 7 U.S.C. ch. 1 (the “Commodity Exchange Act” (“CEA”)) (“Dodd-Frank Act”).

EEI also has more than 65 international electric companies as Affiliate members, and more than 170 industry suppliers and related organizations as Associate members.

Organized in 1933, EEI works closely with all of its members, representing their interests and advocating equitable policies in legislative and regulatory arenas. EEI provides public policy leadership, critical industry data, market opportunities, strategic business intelligence, conferences and forums covering all aspects of the electricity industry, and various products and services to serve the needs of our members and other participants in the electricity industry.

As end users of commodity swaps that are used to hedge commercial risk, EEI's members have a significant interest in how the Commission defines all of the key terms listed in its Advance Notice, but particularly the definitions of "swap," "swap dealer," and "major swap participant." EEI's members are not financial entities. Rather, the typical EEI member is a medium-size electric utility with relatively low leverage and a conservative capital structure.<sup>2</sup> Nevertheless, the way in which the CFTC defines and interprets the key definitions will have a direct and substantial impact on how our members manage their commercial risk. Regulations that make effective risk management options more costly for end users of swaps will make providing consumers with reliable energy more expensive throughout the country.

## **II. Definition of a "Swap"**

### **A. The Commission Should Interpret the Exclusion from the Definition of a "Swap" and the Forward Contract Exclusion Consistently**

The Dodd-Frank Act excludes from the definition of a swap any "sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."<sup>3</sup> This exclusion parallels the long-standing Commodity Exchange Act ("CEA") exclusion of "any sale of any cash commodity for deferred shipment or delivery" from the definition of "future delivery," commonly known as the forward contract exclusion.<sup>4</sup>

Although there is no definitive list of the elements of a physical commodity forward contract, the Commission and the courts have identified the following important characteristics of a forward contract:

- The contract must be between two commercial parties (*e.g.*, a producer, processor, merchandiser, or commercial user of the commodity) that incur risks related to the underlying physical commodity;

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<sup>2</sup> Many EEI members are subject to substantial state regulatory requirements that impose, among other things, significant leverage limitations and minimum capital requirements.

<sup>3</sup> Dodd-Frank Act § 721(a)(21) (to be codified at CEA § 1a(47)(B)(ii)). The exclusion from the definition of a swap in the Dodd-Frank Act refers to the "sale of a nonfinancial commodity." *Id.* Although "nonfinancial commodity" is not defined in the CEA or the CFTC's regulations, EEI presumes that this term is synonymous with commodities that underlie physically settled transactions (*e.g.*, exempt commodities and agricultural commodities).

<sup>4</sup> CEA § 1a(19) (2010). The CEA grants the Commission exclusive jurisdiction over, among other contracts, "transactions involving contracts of sale of a commodity for future delivery." *Id.* § 2(a)(1)(A). However, the CEA limits the Commission's jurisdiction by defining the term "future delivery" to exclude forward contracts.

- The parties to the contract must have the capacity to make or take physical delivery of the underlying commodity;
- The material economic terms (*e.g.*, price, delivery point, duration, credit support, etc.) of the contract must be individually negotiated; and
- The contract must contain a binding delivery obligation.<sup>5</sup>

The commercial and physical characteristics of forward contracts distinguish them from swaps.<sup>6</sup> Therefore, to provide to provide the same legal certainty for physical energy and other commodity contracts in the new regulatory regime, the Commission should interpret the statutory exclusion from the definition of swap and the forward contract exclusion consistently.

Congress plainly intended the Commission and the courts interpret and apply the statutory exclusion from the definition of swap consistently with long-established precedent regarding the forward contract exclusion in the definition of future delivery. In a letter addressed to Representatives Barney Frank and Collin Peterson, Senators Christopher Dodd and Blanche Lincoln, Chairmen of the Senate banking and agricultural committees and principal drafters of the derivatives title (the “Dodd-Lincoln Letter”), confirmed that Congress intended for these two exclusions be interpreted in the same way:

Congress encourages the CFTC to clarify through rulemaking that the exclusion from the definition of swap for ‘any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled’ *is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC’s established policy and orders on this subject.*<sup>7</sup>

In other words, Congress intended that there be a single legal standard for identifying which forward contracts are excluded from the Commission’s jurisdiction, and that the single standard be based upon existing precedent under the forward contract exclusion.

Without legal certainty as to the regulatory treatment of their forward contracts, EEI’s members and other end users who rely on the forward contract exclusion likely will face higher transaction costs due to greater uncertainty. These increased transaction costs may include: (i) more volatile or higher commodity prices; and (ii) increased credit costs, in each case caused by changes in market liquidity as end users change the way they transact in the commodity

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<sup>5</sup> See, *e.g.*, Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. 21,286, 21,294 (Apr. 20, 1993); Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39,188, 39,192 (Sept. 25, 1990); Characteristics Distinguishing Cash and Forward Contracts and “Trade” Options, 50 Fed. Reg. 39,656 (Sept. 30, 1985) (Interpretive Statement of the Office of the General Counsel, CFTC).

<sup>6</sup> For example, a standardized physical transaction, such as a sale of around-the-clock firm (LD) electricity executed in the wholesale power market, is not a swap.

<sup>7</sup> 156 Cong. Reg. H5249 (daily ed. Jun. 30, 2010) (Letter from Sen. Christopher Dodd and Senator Blanche Lincoln to Rep. Barney Frank and Rep. Collin Peterson (“Dodd-Lincoln Letter”)) (emphasis added).

markets.<sup>8</sup> A single regulatory approach that uses the same criteria to confirm that a forward contract is excluded from the Commission’s jurisdiction over swaps and futures will reduce this uncertainty and the associated costs to end users.

**B. The Commission Should Clarify that Forward Contracts will not be Characterized as Swaps Solely Because the Parties Subsequently “Book-Out” Their Delivery Obligations for Commercial Efficiency and Convenience**

A “book-out transaction” is a second agreement between two commercial parties to a forward contract that find themselves in a delivery chain or circle at the same delivery point.<sup>9</sup> When commercial parties “book out” a transaction, they agree to settle their delivery obligations (but not their other obligations) by exchanging a net payment (based on price differences).<sup>10</sup> By allowing the parties to a forward contract to financially settle their delivery obligations to one another rather than actually making or taking delivery of the physical commodity, book-outs eliminate the often substantial transaction costs associated with physical settlement. Significantly, no party to a forward contract is required to agree to book-out a transaction.<sup>11</sup> As a result, the parties to a forward contract retain all of the risks and obligations associated with making or taking delivery of a physical commodity until either a book-out is agreed or physical settlement occurs.<sup>12</sup>

Prior to the passage of the Dodd-Frank Act, the CFTC made clear that the forward contract exclusion encompasses booked-out forward transactions.<sup>13</sup> The CFTC recognized that an evolving commercial landscape necessitated more sophisticated forward contracts that “serve the same commercial functions as the forward contracts which originally were the subject of the [forward contract exclusion] notwithstanding the fact that, in specific cases and as separately agreed to between the parties, the transactions may ultimately result in performance through payment of cash as an alternative to actual physical transfer or delivery of the commodity.”<sup>14</sup>

In its 1990 Statutory Interpretation, the CFTC explained that in the case of a book-out transaction, if the original contract is entered into between commercial participants in connection with their businesses and imposes specific delivery obligations on the parties, the forward

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<sup>8</sup> Wholesale forward contracts for electricity and natural gas are already subject to pervasive regulation by the Federal Energy Regulatory Commission (“FERC”) or the Electric Reliability Council of Texas. *See e.g.*, 16 U.S.C. §§ 825f and 825j. By interpreting the forward contract exclusions from the definitions of swap and future delivery consistently, the Commission will promote the efficient and predictable functioning of these physical markets.

<sup>9</sup> Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. at 21,294; Interpretation Concerning Forward Transactions, 55 Fed. Reg. at 39,192.

<sup>10</sup> Paul Horsnell and Robert Mabro, OIL MARKETS AND PRICES: THE BRENT MARKET AND THE FORMATION OF WORLD OIL PRICES 41 (1993).

<sup>11</sup> Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. at 39,192.

<sup>12</sup> *See id.*

<sup>13</sup> *See* Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. at 21,294; Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. at 39,192.

<sup>14</sup> *In re Bybee*, 945 F.2d 309, 314 (9th Cir. 1991).

contract exclusion still applies.<sup>15</sup> The CFTC emphasized the creation of an enforceable delivery obligation, noting that “any party that is in a position in a distribution chain that provides for the opportunity to book-out with another party or parties in the chain is nevertheless entitled to require delivery of the commodity to be made through it, as required under the contracts.”<sup>16</sup> Because of this delivery obligation and the fact that subsequent book-out transactions are individually-negotiated, separate agreements, the CFTC has consistently concluded that booked-out forward contracts are excluded from its jurisdiction.<sup>17</sup>

Like the CFTC, the Federal Energy Regulatory Commission (“FERC”) treats book-outs as physical transactions. Consistent with the CFTC’s precedent, FERC has defined a book-out transaction as “the offsetting of opposing buy-sell transactions” where “[t]he buyer, seller, price, quantity and other agreement details in such agreements *are indistinguishable from those in any other [physical] power sale agreement.*”<sup>18</sup> As with all other “sales for resale” of electricity in interstate commerce, FERC requires all sellers of wholesale power to report book-out transactions on their Electronic Quarterly Reports. According to FERC, unlike “purely financial transactions,” book-outs (and the transactions that underlie them) are subject to its jurisdiction because they are agreements that “obligate the parties to deliver power at a specified price and, but for the subsequent offsetting power sales, transmission of power would be made.”<sup>19</sup> In other words, whether or not they are booked-out, wholesale power forward contracts are sales of a non-financial commodity for deferred shipment or delivery.

Consistent with Commission precedent and commercial practice, Congress specifically intended for book-outs to continue to be treated as forward contracts and, therefore, excluded from the definition of swap. Notably, Representative Collin Peterson, Chairman of the House Committee on Agriculture, explained that with respect to forward contracts and book-outs, Congress intended *for nothing to change*:

My interpretation of the exclusionary provision from the definition of swap ... is that the exclusion would apply to transactions in which the parties’ delivery obligations are booked-out.... The fact that the parties may subsequently agree to settle their obligations with a payment based on a price difference through a bookout does not turn a forward contract into a swap. Excluding physical forward contracts, including book-outs, is consistent with the CFTC’s longstanding view that physical forward contracts in which the parties later agree to book-out their delivery obligations for commercial

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<sup>15</sup> Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. at 39,192.

<sup>16</sup> *Id.*

<sup>17</sup> *See, e.g.*, CFTC Staff Letter Re: Contract Market Resignation, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. ¶ 27,970 (CFTC Dec. 16, 1999); Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. at 21,294; Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. at 39,192.

<sup>18</sup> Revised Pub. Utility Filing Requirements, Order No. 2001, 67 Fed. Reg. 31,043, at 31,062, FERC Stats. & Regs. ¶ 31,127 (2002) (emphasis added).

<sup>19</sup> *Id.* at 31,063.

convenience are excluded from its jurisdiction. *Nothing in this legislation changes that result with respect to commercial forward contracts.*<sup>20</sup>

Forward contracts are neither futures nor swaps, and, therefore, should remain excluded from the CFTC's jurisdiction. Regulating forward contracts that are subsequently booked-out as swaps would result in significant uncertainty and instability in the physical commodity markets. For example, if forward contracts somehow are transformed into swaps the moment they are booked out, the parties to the swap could potentially (and retroactively) become subject to registration, capital, margin, reporting and other requirements that will be difficult to satisfy, particularly if a considerable amount of time has passed since the original forward contract was executed. Although these regulatory requirements may be appropriate for mitigating risk among financial institutions, they are unnecessary and incompatible with the structure and operations of most commercial enterprises. Congress excluded forward contracts, including those in which the delivery obligations of the parties later are booked-out, from the definition of swap precisely to avoid this result.<sup>21</sup>

### **C. The Commission Should Clarify that Option Contracts that Settle into Forward Contracts are not Swaps**

Commodity option contracts that settle into physically-settled spot contracts or forward contracts are not swaps because, if exercised, they are contracts for the “deferred shipment or delivery” of a commodity that contain binding physical delivery obligations. Like forward contracts, options that settle into spot or forward contracts are used widely by commercial end users to manage price and supply risk. The only material difference between physically-settled options and forward contracts is that, in an option contract, only the option holder has the right (but not the obligation) to require the other party to make or take physical delivery. This difference is not sufficient to justify distinguishing forward contracts and options on forward contracts for purposes of the definition of swap, particularly given the similar ways in which commercial end users use these closely related transactions in practice.

Forward contracts and options that settle into spot or forward contracts provide end users with valuable tools for managing the price risk and other uncertainties associated with their commercial operations. For example, a power marketing company may acquire the capacity of a power plant by purchasing a call option that gives it the right (but not the obligation) to require the writer of the option to deliver energy from the plant at a specified price at any time before the option expires. If the power marketer never exercises its call rights, it has made a payment with no resulting physical delivery of a product, but the option remains a fundamentally physical transaction. At any time before the option expires, the option holder has the absolute right to call for physical delivery of energy. The right to call for physical delivery is consistent with the forward contract exclusion. The Commission should exclude both types of transactions from the definition of swap to ensure that they remain viable risk management tools for end users.

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<sup>20</sup> 156 Cong. Rec. H5247 (daily ed. Jun. 30, 2010) (statement by Rep. Peterson) (emphasis added).

<sup>21</sup> *See id.*

### **III. End Users Should be Excluded from the Definitions of “Swap Dealer” and “Major Swap Participant”**

EEI urges the Commission to ensure that the definitions of swap dealer and major swap participant exclude end users of derivatives. In the text of the Dodd-Frank Act and in numerous statements made by members during the legislative debate, Congress made clear that end users should not be regulated as swap dealers or major swap participants. Notably, the Dodd-Lincoln Letter explained:

In implementing the Swap Dealer and Major Swap Participant provisions, Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies simply because they use swaps to hedge risk in their ordinary course of business. *Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business.* For example, the Major Swap Participant and Swap Dealer definitions are not intended to include an electric or gas utility that purchases commodities that are used either as a source of fuel to produce electricity or to supply gas to retail customers and that uses swaps to hedge or manage the commercial risks associated with its business.<sup>22</sup>

End users rely on cost-effective swaps to hedge and manage the commercial risk associated with their business activities. If end users are categorized as swap dealers or major swap participants, they will be subject to extensive new regulatory requirements, including the requirement to clear virtually all of their swap transactions, including swaps that they use to hedge or mitigate commercial risk.<sup>23</sup> The increased costs of clearing and complying with other new regulatory requirements would substantially reduce the ability of most end users to manage their commercial risk efficiently and economically.

Congress excluded end users from the definitions of swap dealer and major swap participant because they do not contribute to systemic risk and because it would be inappropriate to subject end users to the same the regulatory requirements as swap dealers and major swap participants. Consistent with Congress’s intent, the Commission should clearly exclude end users from the definitions of swap dealer and major swap participant.

#### **A. The Definition of “Swap Dealer” Should Exclude End Users**

The Dodd-Frank Act defines a swap dealer broadly to include any entity that holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties in the ordinary course of business for its own account, or is commonly known as a swap dealer.<sup>24</sup> The Commission should propose a definition of swap dealer that unambiguously excludes end users. Unlike a traditional “dealer” that typically is willing to take either side of a

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<sup>22</sup> 156 Cong. Rec. H5248 (Dodd-Lincoln Letter) (emphasis added).

<sup>23</sup> Many end users are pervasively regulated by FERC and subject to credit provisions and business conduct standards set forth in FERC’s regulations and each entity’s governing tariff.

<sup>24</sup> Dodd-Frank Act § 721(a)(21) (to be codified at CEA § 1a(49)).

swap in an effort to profit from the trade itself, most end users only “trade” swaps in order to hedge commercial risks associated with an underlying physical commodity position.<sup>25</sup> The Commission has distinguished between “dealing” and “trading,” recognizing that each activity is undertaken by market participants for a different purpose and each has a fundamentally different impact on the operation and integrity of the market itself.<sup>26</sup> The Commission should make this same distinction here and exclude end users that predominantly use swaps to hedge the commercial risk associated with their businesses from the definition of swap dealer.

### 1. “Holds Itself Out”

The Commission should clarify that an end user (or an affiliate of an end user) that uses swaps to hedge or mitigate its own (or an affiliate’s) commercial risk does not “hold itself out” as a swap dealer for any class of swaps unless it *actively and continuously* markets itself as a dealer to the general public. The Commission has addressed the meaning of “holding oneself out” in the context of the definition of “commodity trading advisor,” explaining that an entity “holds itself out” if it engages in outward marketing activities, including: promoting itself through mailings, directory listings, and stationery, or otherwise initiating contacts with prospective clients.<sup>27</sup> The Commission similarly should limit the definition of a swap dealer to entities that affirmatively market themselves as dealers.

### 2. “Makes a Market”

“Market making” activity is generally a hallmark of a “dealer.” The Commission should clarify that an end user (or an affiliate of an end user) that uses swaps to hedge or mitigate its own (or an affiliate’s) commercial risk does not “make a market” for any class of swaps unless it *actively and continuously* offers to buy and sell swaps.

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<sup>25</sup> An energy end user is primarily a “trader” in commodity derivatives, engaging in swaps transactions in order to hedge underlying business risks associated with a physical commodity. In contrast, a “dealer” will take the opposite side of a swap transaction with an end user customer as a service to that customer and as part of its core business model. The dealer will typically “flatten” the position incurred in the transaction with the end user customer via an offsetting swap or futures transaction. Therefore, dealers are usually indifferent as to whether they are long or short in a particular market. Notably, the Commission recognized the unique nature of dealing activities recently in the July 2010 Traders in Financial Futures Report (“TFF Report”) (available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/tfmexplanatorynotes.pdf>). The TFF Report separates large traders into four classifications, one of which is “Dealer/Intermediary.” In describing the Dealer/Intermediary, the Commission states in the TFF Report that they “design and sell various financial assets to clients,” and that they “tend to have matched books or offset their risks across markets and clients.” End users fall outside of this description.

<sup>26</sup> For example, the TFF Report distinguishes between “Dealer/Intermediary” activities, such as selling financial products, capturing bid/offer spreads, and otherwise accommodating clients, and all other market activities, which include investing, hedging, managing risk, speculating, and changing the term structure or duration of assets.

<sup>27</sup> Interpretive Letter No. 91-9, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,189 (CFTC Dec. 30, 1991). The Division of Trading and Markets has consistently continued to employ this view. *E.g.*, No-Action Letter No. 02-59, Comm. Fut. L. Rep. (CCH) ¶ 29,063 at \*17 n.22 (CFTC May 17, 2002); Interpretive Letter No. 97-26, Comm. Fut. L. Rep. (CCH) ¶ 27,026 at \*2 (CFTC March. 26, 1997); Interpretive Letter No. 96-72, 1996 CFTC Ltr. LEXIS 123 at \*2 (CFTC Oct. 15, 1996); No-Action Letter No. 95-38, Comm. Fut. L. Rep. (CCH) ¶ 26,379 at \*3 (Dec. 5, 1994).

The fact that an entity both buys and sells commodity swaps consistent with the economics of its commercial business should not be sufficient to treat such an entity as “making a market.” For example, owners of electric generating assets in markets that are not overseen by a regional transmission organization often manage price risk associated with future purchases and sales on a portfolio basis. Because some generating assets are more efficient than others, and because a single power plant is more efficient at certain levels of output, such assets can be modelled and risk-managed according to their marginal (*i.e.*, per-unit of electricity) cost of production. Typically, at any given level of expected production (which corresponds to its forecast of customer demand), each unit of additional electricity produced is more expensive than the preceding unit.

Generators can minimize their total costs (and the overall price of electricity paid by their retail customers) by either buying from or selling to the market when doing so is economical. In this example, a generator can reduce its overall operating costs by: (1) buying power from the market (including the market for financially-settled electricity swaps) when the market price is lower than its marginal cost to increase production;<sup>28</sup> and (2) selling power into the market when the market price is higher than its marginal cost to decrease production. As a direct result of its variable marginal costs and demand obligations, a generator is commonly willing to “buy low and sell high” due to changes in its portfolio of positions or to optimize the value of its assets.

In order to protect their retail customers against volatile prices, EEI’s members and other power and gas producers must be able to buy and sell swaps based on notional quantities of power, gas and other fuels in order to manage their production costs. Such practical use of derivatives does not constitute “making a market” or “dealing” in swaps, and should not cause energy companies to fall within the definition of swap dealer.<sup>29</sup>

### **3. “Regularly Enters into Swaps with Counterparties as an Ordinary Course of Business for its Own Account”**

The Commission should clarify that an entity “regularly enters into swaps with counterparties as an ordinary course of business for its own account” only if its primary business is “dealing” in swaps, as that term is commonly known in the commodity trade. As the Commission has explained in the context of power marketers in the electric power industry: “[a dealer] *does not in the normal course of business hedge or speculate in electricity markets...* [but rather] routinely engage[s] in both buying and selling, including with other [dealers and] power marketers.”<sup>30</sup> End users enter into swaps for precisely the *opposite* purpose. Accordingly, the Commission should define swap dealer to explicitly exclude an end user (or an affiliate of an end user) that primarily uses swaps to hedge or mitigate its own (or an affiliate’s) commercial risk.

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<sup>28</sup> In this case, the generator would actually buy from the spot market, but receive a fixed price from its swap counterparty over the life of the swap.

<sup>29</sup> This is true even in less liquid markets where commercial entities may represent a significant percentage of the overall swap activity. Even though an end user may buy and sell in such a market, it is not “making a market,” and therefore, should not automatically be characterized as a swap dealer.

<sup>30</sup> CFTC No-Action Letter No. 99-67, Comm. Fut. L. Rep (CCH) ¶ 27, 970 (CFTC Dec. 16, 1999).

If the Commission reads this provision literally and treats *any* entity that regularly enters into swaps as part of its business as a swap dealer, without regard as to whether an entity is in fact “dealing” in swaps, virtually every end user that uses swaps primarily to hedge or mitigate commercial risk will be forced to register as a swap dealer. Such an overbroad interpretation would make other provisions of the Dodd-Frank Act meaningless, especially the end user clearing exception. Congress made clear that it did not intend this result.<sup>31</sup>

For the same reason, an entity that, for operational efficiency or convenience, regularly enters into swaps to hedge or mitigate the commercial risk of an end user affiliate should not be treated as a swap dealer.<sup>32</sup> For example, a centralized hedging affiliate that primarily acts as the counterparty to an affiliated end user’s hedge transactions, and then enters into a back-to-back swaps with third-parties (whether through a portfolio of positions or otherwise) should not be regulated as a swap dealer solely due to that activity.

The Commission should clarify that an entity that regularly enters into swaps with counterparties as an ordinary course of business for its own account is only a swap dealer if its business is actually “dealing” in swaps such that it also satisfies one of the other three prongs of the swap dealer definition. End users that use swaps to hedge or mitigate commercial risk, even if they do so as an ordinary course of their business, should not be characterized as swap dealers.

#### **4. “Engages in Activity that Causes the Person to be Commonly Known in the Trade as a Dealer or Market Maker in Swaps”**

Under the fourth prong of the swap dealer definition, a person is a swap dealer if it engages in activity that causes it “to be commonly known in the trade” as a dealer or market maker in swaps. The concept of a person or a transaction being “commonly known” in or to the trade appears in several sections of the CEA.<sup>33</sup> Consistent with its prior precedent, the Commission should determine whether a person is “commonly known in the trade” as a swap dealer based upon the understanding of current dealers, market-makers and other participants in, as well as other persons who have substantial and demonstrable experience with or knowledge about, the market for the relevant class or category of swaps.<sup>34</sup> If the “commonly known”

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<sup>31</sup> 156 Cong. Rec. H5248 (Dodd-Lincoln Letter).

<sup>32</sup> Moreover, for the same reason, such an entity should not be construed as “regularly enter[ing] into swaps with counterparties as an ordinary course of business for its own account.” Dodd-Frank Act § 721(a)(21) (to be codified at CEA § 1a(49)(A)(iii)).

<sup>33</sup> See Dodd-Frank Act § 721(a)(21) (to be codified at CEA § 1a(47)) (definition of “swap”); CEA § 1a(36) (definition of “option”); CEA §§ 2(a)(1)(A), 2(a)(1)(C)(ii), and 2(a)(1)(D)(i) (jurisdiction of the Commission); CEA §§ 4c(a)(2), 4c(a)(5), and 4c(b) (prohibited transactions); CEA §§ 9(c) and (d) (violations of the CEA); CEA § 19(a) (leverage contracts).

<sup>34</sup> In *In re First National Monetary Corp. and Monex Int’l, Ltd.*, the Commission rejected, on appeal, an administrative law judge’s determination that only those witnesses who were currently affiliated with the leverage transaction industry at the time of the adjudication could be considered to be members of that trade. *In re First National Monetary Corp. and Monex Int’l, Ltd.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 at \*8 (CFTC Aug. 7, 1985). The Commission determined that, in addition to the testimony of several persons currently affiliated with entities that were members of the leverage industry, the testimony of an economics professor and a professor of law who specialized in the economics of futures trading could be considered in the determination of whether a transaction was “commonly known to the trade” as a leverage transaction under the CEA. *Id.*

standard is properly applied, few, if any, end users should fall within this prong of the swap dealer definition.

**5. The Commission Should Propose a De Minimis Exception which Excludes Entities that Engage in Limited Swap Dealing with or on Behalf of their Customers**

Assuming that a company otherwise falls within one of the four prongs of the swap dealer definition for one or more categories of swaps, Congress nevertheless provided the Commission with the authority to exempt any entity that engages in “a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers” from the definition of swap dealer.<sup>35</sup> The purpose of the de minimis exception is, among other things, to exempt from the regulatory requirements that apply to companies whose principal business is swap dealing, those entities whose swap “dealing” activities are sufficiently small that they do not contribute to systemic risk. As Senators Christopher Dodd and Blanche Lincoln explained prior to enactment of the Dodd-Frank Act, “Congress incorporated a de minimis exception to the swap dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation.”<sup>36</sup>

Congress charged the Commission with promulgating regulations that identify the “factors” that the Commission will consider in determining whether swap dealing activities are de minimis and, therefore, should be exempted from the definition of swap dealer. EEI is still considering the factors that the Commission should look to in making this determination. At a minimum, those factors should be transparent, objective and measurable, and yet sufficiently flexible so that the Commission can exempt a variety of dealing-type activities which end users and other companies engage in “with or on behalf of their customers” that Congress did not intend to capture in the definition of swap dealer.

In the energy markets, end users sometimes provide services with what some might call dealing attributes to other companies that are their customers for a variety of services. A common example is acting as counterparty to a financial hedge as an “add-on” risk management service provided to a large physical commodity customer or supplier. As long as this type of activity comprises only a small portion of a company’s overall business activity, it should not cause a company that is primarily an end user of swaps to hedge commercial risk to be designated as swap dealer. Continuing with this example, to determine whether the de minimis exception applies, the Commission could measure a person’s customer-oriented dealing activity against that person’s entire portfolio of swap transactions, including swaps used to hedge or mitigate commercial risk. Regardless of the factors that the Commission adopts, the de minimis threshold should be large enough to exclude the swap dealing of end users that is either incidental to providing services to their customers, or a small portion of their business activity.

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<sup>35</sup> Dodd-Frank Act § 721(a)(21) (to be codified at CEA § 1a(49)(D)).

<sup>36</sup> 156 Cong. Rec. H5248 (Dodd-Lincoln Letter).

## B. The Definition of “Major Swap Participant” Should Exclude End Users

### 1. The Definition of “Substantial Position” Must Exclude Transactions that Are Used to Hedge or Mitigate Commercial Risk

The Dodd-Frank Act defines a major swap participant as any person who is not a swap dealer and who maintains a “substantial position” in swaps (excluding positions held for hedging or mitigating commercial risk), whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets, or is a highly leveraged financial entity that holds a substantial position in swaps.<sup>37</sup> The plain language of the definition of major swap participant makes clear that the definition of “substantial position” must exclude transactions that are used to hedge or mitigate commercial risk.

In addition, the Dodd-Frank Act further provides that:

[T]he Commission shall define by rule or regulation the term ‘substantial position’ at the threshold that the Commission determines to be prudent for the effective monitoring, management, and oversight of *entities that are systemically important or can significantly impact the financial system of the United States*. In setting the definition under this subparagraph, the Commission shall consider the person’s relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.<sup>38</sup>

In connection with defining “substantial position,” the Commission should define the meaning of “positions held for hedging or mitigating commercial risk,” and, consequently, define “commercial risk.” Section 721(b) of the Dodd-Frank Act provides that the Commission “may adopt a rule to define ... the term ‘commercial risk;’ and ... any other term included in an amendment to the Commodity Exchange Act.” The term “commercial risk” is an important part of the definition of “major swap participant” and the end user clearing exception. Without a definition of commercial risk, the definition of major swap participant (and other important provisions of the Dodd-Frank Act) will be ambiguous.

The proposed definition of “commercial risk” should accommodate the risk-shifting activities of commercial enterprises and be consistent with related provisions in the CEA, including the end user clearing exception. EEI respectfully suggests that the Commission define commercial risk as follows:

**Commercial Risk.** This term means any risk that a person or governmental entity incurs, or anticipates incurring, related to or in connection with a commodity, or any product or byproduct of a commodity, including, but not limited to: market risk; credit risk; operating risk; transportation and storage

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<sup>37</sup> Dodd-Frank Act § 721(a)(16) (to be codified at CEA § 1a(33)(A)). EEI does not believe that any of its members are “highly leveraged financial entit[ies] that hold a substantial position in swaps.” *Id.*

<sup>38</sup> Dodd-Frank Act § 721(a)(16) (to be codified at CEA § 1a(33) (emphasis added)).

risk; liquidity risk; financial statement risk; and any other risk that can be hedged or mitigated with a swap.<sup>39</sup>

## **2. “Commercial Risk” Should Have the Same Meaning Throughout the CEA**

The term “commercial risk” appears in several sections of the CEA, as amended by the Dodd-Frank Act.<sup>40</sup> The Commission should propose a single definition of “commercial risk” that will have the same meaning everywhere the same words are used in the statute. As a general rule of statutory interpretation, when Congress uses the same words in a single statute it should be presumed, absent evidence to the contrary, that it intended for those words to be given the same meaning wherever they are used.<sup>41</sup> EEI is not aware of any evidence which suggests that Congress intended the meaning of the term “commercial risk” to vary depending upon where it appears in the CEA.

As practical matter, a single, consistent definition of commercial risk is necessary to implement a commercially practicable and coherent regulatory system. For example, if commercial risk is defined more broadly for the purpose of the end user exception than for the definition of major swap participant, a company could face the following “Catch-22:” it would be permitted to rely on the clearing exception for swaps that hedge or mitigate its commercial risk, except that if such swaps cause the company to fall within the definition of major swap participant, it will be disqualified from relying on the clearing exception. This is an unreasonable result that plainly would be contrary to Congress’s intent.

## **3. Substantial Position Should be Defined Qualitatively, Not Quantitatively**

The Commission should define what constitutes a “substantial position” in swaps in terms of the risk and counterparty exposure associated with a portfolio of swap positions.<sup>42</sup> The Dodd-Frank Act explicitly excludes positions in swaps used “for hedging or mitigating commercial risk” from the definition of substantial position for non-financial entities.<sup>43</sup> Congress excluded hedging activity because it determined that transactions which hedge or

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<sup>39</sup> Hedging and mitigating commercial risk does not include activity undertaken to assume the risk of changes in the value of a commodity.

<sup>40</sup> CEA § 1a(19) (definition of “excluded commodity”); Dodd-Frank Act § 721(a)(16) (to be codified at CEA § 1a(33) (definition of “major swap participant”)); *Id.* § 723(a) (to be codified at CEA § 2(h)(7)(A) (general requirements of the end user clearing exception)); *Id.* § 723(a) (to be codified at CEA § 2(h)(7)(D) (treatment of affiliates under the end user clearing exception)).

<sup>41</sup> *Powerex Corp. v. Reliant Energy Servs.*, 551 U.S. 224 (2007) (“A standard principle of statutory construction provides that identical words and phrases within the same statute should normally be given the same meaning.”).

<sup>42</sup> As Representative Collin Peterson stated, the effect of this provision is that, “[f]ew, if any, end users will be major swap participants, as we have excluded ‘positions held for hedging or mitigating commercial risk’ from being considered as a ‘substantial position’ under that definition.” 156 Cong. Rec. H5248 (daily ed. Jun. 30, 2010) (statement of Rep. Peterson); *see also*, 156 Cong. Rec. S5904 (daily ed. Jul. 15, 2010) (statement of Sen. Lincoln)

<sup>43</sup> Dodd-Frank Act § 721(a)(16) (to be codified at CEA § 1a(33)).

mitigate commercial risk are *not* associated with the risk factors that contributed to the recent financial crisis.<sup>44</sup>

The Commission should similarly exclude all other collateralized swaps that do not significantly increase systemic risk. As Senator Blanche Lincoln noted prior to enactment of the Dodd-Frank Act, “[b]ilateral collateralization and proper segregation *substantially reduces* the potential for adverse effects on the stability of the market. Entities that are not excessively leveraged and have taken the necessary steps to segregate and fully collateralize swap positions on a bilateral basis with their counterparties should be viewed differently.”<sup>45</sup> Treating all swaps as equal, regardless of the quality of their counterparties and supporting collateral would result in an over-broad definition of major swap participant that might force many companies to comply with additional regulation that does little to enhance the stability or integrity of the financial system.

#### **4. Inter-Affiliate Transactions Should Be Excluded from the Determination of Whether a Person Maintains a Substantial Position in Swaps**

Inter-affiliate transactions should be excluded when determining whether a company maintains a substantial position in swaps. Many end users hedge their commercial risk through affiliated entities for operational efficiency or convenience. The end user clearing exception recognizes this common commercial practice by expressly permitting end users to enter into swaps through affiliated non-financial entities while still relying on the clearing exception.

The Commission should clarify that inter-affiliate transactions that are associated with the hedging and management of commercial risk are similarly excluded from the determination of whether a person maintains a substantial position in swaps. If hedging transactions entered into through an affiliate are included when determining whether an end user or its affiliate maintains a substantial position in swaps, end users potentially will be subject to radically different regulatory requirements based solely on how their operations happen to be structured. Congress did not intend for the Dodd-Frank Act (or the Commission) to make such an arbitrary distinction.

#### **5. End Users are not “Systemically Important” and Cannot Significantly Impact the Financial System of the United States**

The Dodd-Frank Act also defines a major swap participant as any person whose “outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.”<sup>46</sup> End users are objectively small participants in the swap markets who use swaps to transfer rather than to assume risk. End users *cannot* contribute significantly to systemic risk or have a “serious adverse affect” on the stability of the financial markets. As Representative Peterson stated in the

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<sup>44</sup> See 156 Cong. Rec. H5245 (daily ed. Jun 30, 2010) (statement of Rep. Peterson) (noting through colloquy that Congress drafted the Dodd-Frank Act with the intent of continuing to allow end user hedging).

<sup>45</sup> 156 Cong. Rec. S5907 (daily ed. Jul. 15, 2010) (statement of Rep. Lincoln) (emphasis added).

<sup>46</sup> Dodd-Frank Act § 721(a)(16) (to be codified at CEA § 1a(33)).

Congressional record, Congress did not intend to limit the hedging activities of end users when it enacted the Dodd-Frank Act:

In crafting the House bill and the conference report, we focused on creating a regulatory approach that permits the so-called end users to continue using derivatives to hedge risks associated with their underlying businesses, whether it is energy exploration, manufacturing, or commercial activities. End users did not cause the financial crisis of 2008. They were actually the victims of it.<sup>47</sup>

The Commission should clarify that end users do not contribute to systemic risk, and should expressly exclude them from the definition of major swap participant under the Dodd-Frank Act.

#### **IV. Conclusion**

EI commends the Commission for its commitment to safeguarding the hedging and trading activities of end users of physical commodities and swaps, and looks forward to working with the Commission throughout the Dodd-Frank Act rulemaking process. As explained herein, we encourage the Commission to define the Dodd-Frank Act's key terms to exclude commercial end users. We welcome the opportunity to discuss these issues further with the Commission and its Staff.

Please contact me at (202) 508-5571, or Aaron Trent, Manager, Financial Analysis, at (202) 508-5526, if you have any questions regarding EEI's comments.

Respectfully submitted,



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Richard F. McMahon, Jr.  
Executive Director

cc (by e-mail):

[rule-comments@sec.gov](mailto:rule-comments@sec.gov)

SEC File Number S7-16-10

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<sup>47</sup> 156 Cong. Rec. H5245 (daily ed. Jun 30, 2010) (statement of Rep. Peterson).

**“PROFILES” OF INDIVIDUAL NFP ENERGY END USERS**

See Attached

CH2\9302491.5

## Hypothetical Electric Distribution Cooperative in Midwest\*

Type of utility: Hypothetical Electric Distribution Cooperative

Description of customer base: Serving 22,000 members in suburban and rural areas of a Midwest. No owned generation assets; member of a generation and transmission cooperative.

Risk management/hedging policy description: Prohibition against speculation following guidelines and regulations of the Rural Utilities Service of the US Department of Agriculture

Recordkeeping procedures: All contracts and records are retained in accordance with the records retention policy of the Rural Utilities Service of the US Department of Agriculture

Types of counterparties: Typically other utilities (cooperative, municipal, or investor-owned)

Types of commodities/products used: Forward contracts and options for physical delivery of electricity. Zero to ten fixed to RTO price swaps for small amounts of power.

What happens to gains/losses from these activities: passed through to members of the cooperative through changes in rates for electric service

### **Current collateral posting requirements**

What is the typical collateral threshold amount in your hedging contracts, if there is one? No thresholds on contractual obligations. All obligations are unsecured.

How often is collateral or margin reevaluated and exchanged while a transaction is outstanding?  
N/A

In what form do you post collateral for your hedging transactions?  
N/A

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\* For this smaller NFP Energy End User profile, we have provided a hypothetical. This profile represents the vast majority of NFP Energy End Users, who may (or may not) enter into one or a few “price protection” or other energy or fuel supply or energy sales financial hedging transactions from time to time. Again, we refer you to our comment letter on the Definitions ANOPR. We assume for purposes of this profile, that physical forward gas, power and other nonfinancial commodity transactions and commercial options are not “swaps.” Nonetheless, the small NFP Energy End Users need the ability to enter into non-cleared financial price hedging transactions, which may fall within the definition of “swap” as an important risk management tool. These small NFP Energy End Users need to maintain their ability to cost-effectively use “non-cleared swaps” to manage their commercial risks without burdensome or costly new regulatory requirements.

Approximately what percentage of your hedging contracts involve collateral obligations?

N/A

Credit ratings: Not rated by a credit rating agency. Our lenders and contract counterparties perform internal credit assessment and may monitor our ability to meet our mortgage covenants.

Ability of system to raise rates if needed to ensure fiscal stability: Our mortgage covenants require us to raise our rates to meet our minimum mortgage financial covenants. Our board of directors must approve any changes in rates.

Use of outside advisors: We utilize engineering firms for cost of service studies and our legal counsel assists us with contractual matters. We do not use outside advisors for power supply advice. We sometimes consult with our G&T cooperative.

CH2\9355294.2

## Public Power Utility in the Pacific Northwest

Region: Pacific northwest portion of the Western Electricity Coordinating Council (WECC).

Type of utility: Mid-size municipal corporation with service to over 180,000 customers.

Description of customer base: Mix of residential, commercial and industrial. Estimated to be about 53% residential, 30% commercial and 17% industrial.

Owned generation: 248 megawatt (MW) combined cycle combustion turbine generator fired with natural gas.

Purchased generation and transmission – The utility’s power supply portfolio includes purchased power contracts with the Bonneville Power Administration (BPA) and, to meet the state renewable energy requirements, a power supply contract for energy from a wind generator. The electric system has contractual rights to over 48 MMBtus per day natural gas transportation capacity on the Northwest Pipeline, and has contractual point-to-point and network integration transmission rights from BPA for electric transmission requirements.

Risk management/hedging policy description: The utility has adopted by resolution a hedging policy to meet the utility’s energy loads. The policy prohibits speculative trading; the net supply position cannot exceed the utility’s forecasted load requirements. Any displacement of the generation facility must result in an increase in savings over the original position. Multiple hedging tools may be used – including options, swaps, swaptions, and futures – however, the utility’s hedging tool of choice is a swap. Our risk management time horizon is five years, although few transactions extend beyond 3 years.

Recordkeeping procedures: Every transaction is conducted on a recorded telephone line and entered into our system of record. The transaction is followed up with a written “confirm” executed by both parties and retained and transmitted pursuant to the underlying umbrella contract, which in our case is normally an ISDA contract.

Types of counterparties: Balanced counterparty portfolio, including utilities, marketers, producers, and banks.

Types of commodities/products used: Natural gas and electricity – other products are allowed under the risk policy, however. For natural gas, we use nearly 100% OTC swaps (with ISDA or NAESB master agreements) rather than NYMEX contracts to hedge.

What happens to gains/losses from these activities: Transactions are not entered into in order to make a profit. We need fuel supply, and so we lock in our forward prices with a financial product. We do not speculate so there is no gain or loss over our original position. We may unwind a hedge if we determine that we can save money by not running the plant. Those savings are a reduction in costs in the budget, and the monies would be applied to future fuel needs.

Current collateral posting requirements: The utility is subject to posting cash, letters of credit or other forms of security. However, our internal collateral management procedures have successfully avoided any posting of collateral or margin call in the utility's hedging history. The utility almost always is a net buyer so we have never had a counterparty's credit exposure to us exceed more than a few million dollars. The utility's commercial gas hedging transactions do not result in any threat to the United States' banking and financial systems. If the utility's commercial hedging transactions are included as regulated swaps or commodities, the end result will not be increased stability for the banking and financial systems, but rather will be significant financial distress to the utility and its customers.

What is the typical collateral threshold amount in your hedging contracts, if there is one? There is a collateral threshold. It is dynamic and is based on the ratings of the counterparties.

How often is collateral or margin reevaluated and exchanged while a transaction is outstanding? Collateral and margin are evaluated daily and would be exchanged only if a credit event occurs or if a threshold is exceeded.

In what form do you post collateral for your hedging transactions? To date, the district has avoided posting collateral, however we would prefer to post in cash or letter of credit, if required.

Approximately what percentage of your hedging contracts involve collateral obligations? We could be required to post collateral – and we have the right to request collateral – in 100% of our contracts, but in fact, have never had to post collateral because of our credit management procedures.

Credit ratings: Rated “A” by Standard & Poor's and Moody's.

Ability of system to raise rates if needed to ensure fiscal stability: Can raise rates with a public meeting, and have done so in less than 3 weeks.

Use of outside advisors: None that assist us in hedging our power supply risk. We have a risk management department with experience in credit, collateral, market, default, and pricing risk management, and a demonstrated ability in maximizing the use of unsecured credit (under collateral thresholds of our ISDAs) while protecting our ratepayers from default risk. We have a gas department – with experience with financial products – that manages our forward hedging portfolio.

Pledge of Assets: The utility has outstanding approximately \$220 million of Electric System revenue bonds and \$180 million of Generating System revenue bonds. The bond resolutions pledge to holders of its revenue bonds that the utility will not encumber either the Electric System or the Generating System with any lien except for certain parity revenue obligations, none of which provide an exception for pledging the assets of either system for commercial hedging transactions. Extending the pledge of assets against over

the counter transactions would be an impairment of the pledge previously given to bondholders.

CH2\9343316.2

## Public Gas Entity in Southeast

Type of utility: Municipal – Public Gas Joint Action Agency

Description of customer base: 78 Member Cities serving 227,000 customers

Risk management/hedging policy description: hedge policy attached

Recordkeeping procedures: Each hedge is documented. Hard copies kept onsite 3 years. All hedge documentation scanned and stored in Laserfiche. Hedge data elements also recorded and stored in Oracle database and Excel spreadsheets.

Types of counterparties: Typically banks and energy producers

Types of commodities/products used: natural gas/fixed price swaps, calls, puts, combinations, swaptions, basis swaps, location options

What happens to gains/losses from these activities: passed through to Member Cities and ultimately their customers through rates

### **Current collateral posting requirements**

What is the typical collateral threshold amount in your hedging contracts, if there is one? No thresholds on OTC transactions. All our OTC transactions are unsecured. We occasionally hold futures positions, which require margin.

How often is collateral or margin reevaluated and exchanged while a transaction is outstanding?  
N/A

In what form do you post collateral for your hedging transactions? If we hold futures positions we use cash. Typically we don't hold futures because of the fluctuating cash amounts and administrative burdens required to hold positions.

Approximately what percentage of your hedging contracts involve collateral obligations? Less than 1% (futures contracts).

Credit ratings: Our hedge policy requires counterparties to hold AA- or higher rating for transactions two years or greater to maturity. An A- rating is required for hedges less than two years to maturity.

Ability of system to raise rates if needed to ensure fiscal stability: Our Member City contracts require systems to raise rates or raise taxes to meet obligations.

Use of outside advisors: We do not typically rely on outside advisors prior to executing hedge transactions. We have in-house expertise, but do have a relationship with (our Introducing Broker for Futures) to discuss market conditions and strategy from time to time.

# [PUBLIC GAS ENTITY IN SOUTHEAST (“PGE”)]

## Hedge Policy

*Effective: [Date]*

### DEFINITIONS

**HEDGE** — A hedge is a financial instrument used to manage the interest rate or commodity price risk involved with the purchase and sale of natural gas. A hedge may also be appropriate to manage price risk associated with the purchasing and storing of natural gas.

A hedge is used by PGE to manage the risk associated with normal business activities of buying or selling commodities or financial instruments. To qualify as a hedge there must be at least an 80% correlation between the hedging instrument and the underlying asset being hedged such as a commodity or interest rate.

**SPECULATION** - Speculation does not manage the risk associated with PGE's normal business activities, and will not be utilized at any time.

**FINANCIAL INSTRUMENTS** — Financial instruments shall include derivative products such as over-the-counter (OTC) instruments, for example, but not limited to options and swaps and the various combinations of such products. It may also include exchange-traded instruments such as futures and options.

### POLICY

PGE will engage only in financial hedge transactions that are consistent with prudent risk management practices related to PGE's gas sales or acquisition commitments (including fixed price commitments made to municipalities such as members, other agencies and non-member entities for industrial customers or for the municipalities' own system supply) or existing assets and liabilities and foreseeable future purchase and sales requirements.

Hedges for municipalities that PGE serves on a non-supply basis with services such as consulting and administrative services are not covered by this policy and will be addressed as a separate PGE service offered with board authorization.

All interest rate hedges with a maximum notional amount of \$[#] and commodity hedges with total notional volumes greater than [#] cubic feet require board authorization via a resolution of the Board.

Employees of PGE shall not directly or indirectly own or trade in energy futures contracts or options on energy futures contracts for their own accounts.

PGE shall not trade financial hedge instruments with a Counterparty unless the Counterparty meets the following credit criteria:

(i) Counterparty's obligations are rated, or are insured or guaranteed by an entity whose obligations are rated, for any hedge with a term of [#] years or greater, in one of the two highest rating categories, without regard to gradations within a category, of any nationally recognized rating service, and for any hedge with a term of less than [#] years, in one of the three highest rating categories, without regard to gradations within a category, of any nationally recognized rating service, or

(ii) the Counterparty's exposure to PGE pursuant to such agreements is collateralized at [#]% of the market value of such exposure, marked to market no less frequently than quarterly.

PGE may limit or refuse to trade financial hedge instruments on behalf of non-PGE municipalities (defined as municipalities that have not executed contracts substantially similar to the Gas Supply Contracts, dated as of January 1, [Date], with the Members as supplemented from time to time pursuant to the terms thereof). PGE may determine to trade financial hedge instruments on behalf of non-PGE municipalities rated investment grade or higher by any nationally recognized rating agency such as Moody's, Standard & Poor's or Fitch IBCA. If a non-PGE municipality does not have a rating from one of the nationally recognized rating agencies, PGE may evaluate the municipality's financial condition for creditworthiness and determine to trade financial hedge instruments on its behalf with appropriate volume and/or dollar limitations.

#### **COUNTERPARTY AUTHORIZATION**

Based on the credit criteria referenced above, PGE will execute master swap agreements and maintain relationships with a sufficient number of acceptable Counterparties to insure a competitive environment to price the applicable hedging transactions. Authorization for negotiating and executing these agreements will be provided by the Board via resolution on an as needed basis.

#### **HEDGE COMMITTEE**

A Hedge Committee will oversee the activities of this program. The committee shall be comprised of at least one of the following officers: the President and CEO, the Chief Financial Officer, or the Vice President of Gas Supply and Operations, and the persons in charge of (a) managing short-term supplies, (b) executing hedges and (c) providing retail rate advice to PGE municipalities or other staff designated by the President and CEO from time to time.

The role of the Hedge Committee will be to determine whether a proposed transaction is a bona fide hedge, choose the hedge vehicle to be utilized and review the performance of the hedging activity on a monthly basis. The Hedge Committee shall meet at least monthly, and may meet more often if needed. A member of the Hedge Committee shall be appointed to keep minutes of the meetings. The Hedge Committee shall provide the Audit and Finance Committee a summary of its activity every six months.

#### **LIMITS AND AUTHORITY**

The notional volume of hedging instruments shall not be greater than the contractual

volume of offsetting "physical" market agreements. The Hedge Committee will review all transactions to make sure they are consistent with this policy and the procedures of PGE.

A request for a commodity hedge (either by a municipality or the Hedge Committee) shall be documented on a "trade sheet" and presented to any Hedge Committee member for a signature of approval. Oral approval is adequate if there is not a Hedge Committee member within the PGE office. However, the trade sheet must be signed immediately upon their return to the PGE office. Interest rate hedges will be developed by Finance and approved by the Chief Financial Officer and the President and CEO.

### **PROCEDURES-HEDGED PRICING**

A municipality receiving physical supply services may request a hedged price (i.e., swap, collar or cap) instead of the PGE spot market price (SMP) for the purpose of offering a hedged price to an industrial customer, as well as hedging a municipality's base load supply. Under this option as described below, the municipality will pay the normally applicable SMP plus a surcharge/(credit) each month which will result in a net hedged price to the municipality. PGE will adhere to the following procedures when a hedged price is requested.

1. The municipality shall identify the quantity to be hedged ("hedged quantity") and period of time (minimum of one month) that a hedged natural gas price(s) is requested.
2. When feasible, PGE will solicit bids from qualified counterparties to hedge at a hedged price(s) for the quantity and period specified in (1). The Counterparty will identify the price(s) at which they are willing to enter into a price swap or option agreement with PGE. Under the price swap (forward purchase) or option agreement they will pay PGE the difference between the hedged price and the SMP in any month that the SMP exceeds the hedged price. When the hedged price is more than the SMP, PGE will pay them the difference. In both cases, the price difference will be applied to the hedged quantity times the number of days in the month.

PGE shall bill surcharges or credits equal to those paid to or received from the Counterparty. These surcharges or credits are in addition to all normally applicable gas supply charges. The municipality shall execute an agreement with PGE to this effect. The combination of the SMP and the appropriate surcharges or credits will thus result in a hedged price to the municipality.

3. Upon completion of any hedge, the designated Finance staff (primary), designated Supply staff (secondary) or the designated Member Services staff (secondary) shall provide confirmation of the hedge transaction to the President and CEO, and municipality. The designated Finance staff shall then update the PGE hedge portfolio and provide payment details to the Accounting department in order to wire funds, if necessary, to the Counterparty.

## Supplement To Natural Gas Hedge Policy

I have read and understand the attached Natural Gas Hedge Policy and will adhere to the policies and procedures.

\_\_\_\_\_  
President and CEO Date

\_\_\_\_\_  
Chief Financial Officer  
(Assistant Secretary-Treasurer) Date

\_\_\_\_\_  
Vice President, Gas Supply  
and Operations Date

\_\_\_\_\_  
Designated Finance Staff Date

\_\_\_\_\_  
Designated Supply Staff Date

\_\_\_\_\_  
Designated Member Services Staff Date

## Mid-sized Generation and Transmission Cooperative in the Midwest

Region: Midwestern United States, Midwest ISO (MISO)

Type of utility: Mid-size Generation & Transmission Cooperative

Description of customer base: 28 Rural Electric Coops and 2 non-coop members serving approximately 374,000 customer meters

Owned generation and transmission: This coop has a 25% interest in a 625 MW coal-fired unit, a 50% interest in a gasification plant providing steam and synthetic gas to the coop's 260 MW plant, a 50% interest in a 630 MW combined-cycle plant, 33MW of landfill gas generation, and 246 MW of gas-fired peaking power.

Purchased generation and transmission: A portfolio of purchase power agreements is used to satisfy the remainder of the cooperative's load requirements. These agreements total approximately 950 MWs and include fixed price, unit contingent, and cost-based transactions, all of which expire on or before December 31, 2032. The coop also has network transmission service agreements with various utilities to ensure delivery of the power.

FTRs (or comparable transactions in the specific RTO) holdings to support transmission/power supply transactions: As a firm transmission customer the cooperative is eligible to participate in MISO's Auction Revenue Rights Allocation (ARR) and Financial Transmission Rights (FTR) auction market. FTRs are a financial hedging tool and do not convey physical transmission rights. The cooperative purchases and sells FTRs to match the current energy supply to the current energy demand with the goal of hedging, or fixing, the price differential for a month or year(s) between power sources (where generation is located) and load "sinks" (where the customers are located). This may include selling FTRs that were based on historical ARR rights that are no longer applicable to the current energy portfolio. The cooperatives hedge policies do not allow speculative positions.

Energy risk management/hedging policy description: The cooperative has an energy risk management policy that outlines the following objectives: maintain risk within desired tolerances for a defined period in the future, mitigate price volatility, optimize the value of power supply assets/resources, participate in commodity markets and derivative instruments for hedging only and not for speculative purposes, and to develop a risk management culture.

The cooperative has a hedge policy that guides disciplined hedging of forward power supply portfolio components. This hedge policy is designed to reduce member wholesale rate volatility and to maintain rates within desired tolerances. The hedge policy identifies specific time and volume (as a % of total projected native load) criteria for procuring projected power supply portfolio components. This policy largely employs a price-averaging strategy of declining percentage of power supply portfolio components held over forward time periods. This strategy protects the cooperative from potential adverse impacts that could result in either significant price increases or decreases. Reporting policy compliance to the Board is a key component of the hedge policy.

The cooperative uses a total energy hedging approach for their hedge policy. For policy compliance, energy needs are considered hedged or procured to the extent that the projected need is met by; i) Authorized power transactions, as defined in the cooperative's trading authority policy, or ii) Authorized fuel transactions combined with physical generation unit ownership, heat rate transactions, or physical capacity transactions. Option transactions with out of the money strike prices may be used to hedge forward volumes, provided that they do not account for more than a small defined % of the projected energy needs in any given month.

The cooperative utilizes a full array of hedging instruments, including physical and financial derivatives. The cooperative has a trading authority policy that outlines the allowable trading instruments, procedures, and authority approval requirements to enter transactions. This cooperative has ISDA master agreements in place under which the cooperative transacts in financial derivatives.

Recordkeeping procedures: All transactions are executed via recorded phone lines or on-line brokers. All phone lines of traders are recorded and stored electronically. Traders capture all transactions in the energy trading and risk management (ETRM) system promptly after execution. Traders generate, review, sign, and date transaction reports from the ETRM system each day. Written confirmations are automatically generated out of the ETRM system each day. The middle office prepares, reviews, signs, and faxes to the counterparty a hard copy confirmation letter for each transaction, except for those executed with a clearing broker. Clearing broker transactions are reconciled daily to broker statements. The middle office verifies all external confirmations to ensure the transaction details match the ETRM system. The back office checks out with counterparties on a monthly basis and generates invoices directly from the ETRM system. For clearing broker transactions, the back office reconciles monthly broker statements to the ETRM system. All transactional records are retained in compliance with FERC records retention requirements.

Types of counterparties: This coop currently uses 73 counterparties including the MISO, banks, utilities, producers, and marketers

Types of commodities/products used: NYMEX natural gas futures, OTC natural gas swaps, long-term power purchase agreements for physical power, wind, long-term point to point and network transmission, Financial Transmission Rights (FTRs), Renewable Energy Credits, SO<sub>2</sub> and NO<sub>x</sub> emission allowances

What happens to gains/losses from these activities: Unrealized gains and losses from financial transactions are recorded on the balance sheet as a deferred asset or liability. Once the positions are cash settled, any gain or loss is taken against income as a component in determining net power costs.

Current collateral posting requirements: None

What is the typical collateral threshold amount in your hedging contracts, if there is one? Collateral thresholds vary from \$10 million to \$40 million. The cooperative manages its

transactions with various counterparties in order to avoid having to post collateral by keeping net exposures below the applicable threshold.

How often is collateral or margin reevaluated and exchanged while a transaction is outstanding? Collateral or margin requirements are calculated daily and, if required, margins would be posted or called daily.

In what form do you post collateral for your hedging transactions? This coop posts both cash and Letters of Credit.

Approximately what percentage of your hedging contracts involve collateral obligations? None of the hedging contracts currently have collateral obligations.

Credit ratings: A-/Stable S&P Long Term Rating

Ability of system to raise rates if needed to ensure fiscal stability: The coop is governed by the FERC for rate making purposes and has a formula rate that defines the calculation and types of expenditures that are included for rate setting purposes. The coop's Board of Directors, made up of member-owners, has responsibility for approving the inputs into the approved formula with no further action required by FERC. Rates are set annually based on the current year's operating budget (formula inputs), as approved by the Board. Quarterly, the Board makes a determination on whether to modify the current rate level. Their decision is based on actual results to date and the latest financial projections.

Use of outside advisors: Consulting services of ACES Power Marketing are used for all risk management activities.

## Mid-Sized Generation and Transmission Cooperative in the Midwest

Region: Midwestern United States, Midwest ISO (MISO)

Size/Type of utility: Mid-size generation and transmission cooperative

Description of customer base: Provides wholesale electric service and transmission to 18 member distribution cooperatives who in turn serve approximately 800,000 customers consisting of residential, business, industrial, and farms.

Owned generation and transmission: 1,320 megawatts of coal generating capacity, 350 megawatts of natural gas generating capacity, and 2 MW Landfill Methane renewable energy generation. Joint ownership in a 627 megawatt combined cycle plant. Owns over 1,400 miles of transmission lines.

Purchased generation and transmission: The cooperative has power purchase agreements with another utility to receive 200 megawatts (MW) of power. The cooperative is a member of the Midwest Independent System Operator (MISO) which ensures delivery of the power.

FTRs (or comparable transactions in the specific RTO) holdings to support transmission/power supply transactions: As a firm transmission customer the cooperative is eligible to participate in MISO's Auction Revenue Rights Allocation (ARR) and Financial Transmission Rights (FTR) auction market. FTRs are a financial hedging tool and do not convey physical transmission rights. The cooperative purchases and sells FTRs to match the current energy supply to the current energy demand with the goal of hedging, or fixing, the price differential for a month or year(s) between power sources (where generation is located) and load "sinks" (where the customers are located). This may include selling FTRs that were based on historical ARR rights that are no longer applicable to the current energy portfolio. The cooperatives hedge policies do not allow speculative positions.

Energy risk management/hedging policy description: The cooperative has an energy risk management policy that outlines the following objectives: maintain risk within desired tolerances for a defined period in the future, mitigate price volatility, optimize the value of power supply assets/resources, participate in commodity markets and derivative instruments for hedging and not for speculative purposes, and to develop a risk management culture.

The cooperative has a hedge policy that guides disciplined hedging of forward power supply portfolio components. This hedge policy is designed to reduce member wholesale rate volatility and to maintain rates within desired tolerances. The hedge policy identifies specific time and volume (as a % of total projected native load) criteria for procuring projected power supply portfolio components. This policy largely employs a price-averaging strategy of declining percentage of power supply portfolio components held over forward time periods. This strategy protects the cooperative from potential adverse impacts that could result in either significant price increases or decreases. Reporting hedge policy compliance to the Board is a key component of the policy.

The cooperative uses a total energy hedging approach for its hedge policy. For policy compliance, energy needs are considered hedged to the extent that the projected need is met by; i) Authorized power transactions, as defined in the cooperative's trading authority policy, or ii) Authorized fuel transactions combined with physical generation unit ownership, heat rate transactions, or physical capacity transactions. Option transactions with out of the money strike prices may be used to hedge forward volumes, provided that they do not account for more than a small defined % of the projected energy needs in any given month.

The cooperative utilizes a full array of hedging instruments, including physical and financial derivatives. The cooperative has a trading authority policy that outlines the allowable trading instruments, procedures, and authority approval requirements to enter transactions. This cooperative has ISDA master agreement in place under which it transacts financial derivatives.

Recordkeeping procedures: All transactions are executed via recorded phone lines or on-line brokers. All phone lines of traders are recorded and stored electronically. Traders capture all transactions in the energy trading and risk management (ETRM) system promptly after execution. Traders generate, review, sign, and date transaction reports from the ETRM system each day. Written confirmations are automatically generated out of the ETRM system each day. The middle office prepares, reviews, signs, and faxes to the counterparty a hard copy confirmation letter for each transaction, except for those executed with a clearing broker. Clearing broker transactions are reconciled daily to broker statements. The middle office verifies all external confirmations to ensure the transaction details match the ETRM system. The back office checks out with counterparties on a monthly basis and generates invoices directly from the ETRM system. For clearing broker transactions, the back office reconciles monthly broker statements to the ETRM system. All transactional records are retained in compliance with FERC records retention requirements.

Types of counterparties: Counterparty portfolio consists of banks, cooperatives, and power producers. This cooperative has 5 ISDA counterparties.

Types of commodities/products used: NYMEX (natural gas futures, natural gas options, heating oil futures, heating oil options), OTC natural gas swaps, long-term power purchase agreements for physical power, long-term point to point and network transmission, Financial Transmission Rights (FTRs), Renewable Energy Credits, SO<sub>2</sub> and NO<sub>x</sub> emission allowances

What happens to gains/losses from these activities: Gains/losses from financial hedging activities are netted against physical transactions which ultimately determine the net commodity cost for the cooperative.

Current collateral posting requirements: No margin posted, not currently applicable.

What is the typical collateral threshold amount in your hedging contracts, if there is one? The typical range is \$2.5 to \$15 million, with an average of approximately \$5 million. The cooperative manages its transactions with various counterparties in order to avoid having to post collateral by keeping exposures to any counterparties below the applicable threshold.

How often is collateral or margin reevaluated and exchanged while a transaction is outstanding?  
Daily when applicable.

In what form do you post collateral for your hedging transactions? Cash

Approximately what percentage of your hedging contracts involve collateral obligations? None of the hedging contracts currently have collateral obligations.

Credit ratings: Standard and Poor's rating: A  
Moody's rating: Baa2

Ability of system to raise rates if needed to ensure fiscal stability: The members of the cooperative are also its ultimate rate-payers. The cooperative has autonomous authority to establish the rates charged for all services, with broad oversight performed by the Rural Utilities Service under the U.S. Department of Agriculture. Changes in rates occur by action of the cooperative's Board of Directors, which is elected by the members. The cooperative's rate structure also includes an automatic power cost adjustment mechanism whereby rates are adjusted on a quarterly basis for changes in commodity costs and the associated costs of hedging without additional action by the Board.

Use of outside advisors:  
Consulting services of ACES Power Marketing are used for risk management activities.

## Large Generation and Transmission Cooperative in the Southeast

Region: Southeastern United States, PJM

Type of utility: Large Generation and Transmission Cooperative

Description of customer base: Provides wholesale electric service and transmission to 25 electric distribution cooperatives serving approximately 1 million customer meters.

Owned generation and transmission: Generation portfolio includes 682 MW of nuclear generation, 18 MW of diesel generation, and 620 MW of natural gas fired combustion turbines. Additionally, the utility owns approximately 500 MWs of import transmission capacity.

Purchased generation and transmission: The cooperative has a diverse power supply portfolio to supply the power requirements and obligations of its members. The portfolio includes purchased power agreements (PPAs) with investor-owned utilities and merchant generation resources

FTR holdings to support transmission/power supply transactions: As a load serving entity the cooperative is eligible to participate in PJM's Auction Revenue Rights Allocation (ARR) and Financial Transmission Rights (FTR) auction market. FTRs are a financial hedging tool and do not convey physical transmission rights. The cooperative purchases and sells FTRs to match the forecasted member load to the portfolio energy supply with the goal of hedging, or fixing, the price differential for a month or year(s) between power sources (where the generator is located) and "sinks" (where the customers are located). The cooperative's hedge policies do not allow speculative positions.

Risk management/hedging policy description: The cooperative has energy risk management, trading authority and credit policies that outline the following objectives: maintain risk within desired tolerances for a defined period in the future, mitigate price volatility, optimize the value of power supply assets/resources, participate in commodity markets and derivative instruments for hedging and not for speculative purposes, and develop a risk management culture.

The cooperative has a hedge program that guides disciplined hedging of forward power supply portfolio components. This hedge policy is designed to reduce commodity price volatility which provides member wholesale rate stability.. The hedge policy identifies specific time and volume (as a % of total projected native load) criteria for procuring projected power supply portfolio components. The cooperative utilizes a full array of hedging instruments, including physical and financial derivatives. The cooperative has a trading authority policy that outlines the allowable trading instruments, procedures, and authority approval requirements to enter transactions. This cooperative has ISDA master agreements in place under which the coop transacts in financial derivatives.

Recordkeeping procedures: All transactions are executed via recorded phone lines or on-line brokers with the exception of the PJM ARR and FTR transactions which are executed through the PJM administered web portal. All transactions are captured in the energy trading and risk

management (ETRM) system and reviewed and verified by middle office personnel. Written confirmations are automatically generated out of the ETRM system each day. The back office checks out with counterparties on a monthly basis and generates invoices directly from the ETRM system. For clearing broker transactions, the back office reconciles monthly broker statements to the ETRM system. All transactional records are retained in compliance with FERC records retention requirements.

Types of counterparties: This cooperative transacts with roughly 20 counterparties. The counterparties include utilities, marketers, banks, Regional Transmission Organization and government agencies.

Types of commodities/products used: NYMEX (natural gas futures and options, heating oil futures), OTC (natural gas swaps, options, heating oil swaps), long-term power purchase agreements for physical power and renewable energy, long-term point to point and network transmission, Financial Transmission Rights (FTRs), Renewable Energy Credits, SO<sub>2</sub> and NO<sub>x</sub> Emission Allowances

What happens to gains/losses from these activities: Gains or losses from financial hedging activities are netted against the cost of the underlying power supply resource.

Current collateral posting requirements: This cooperative is using Letters of Credit as its only form of collateral/margin, other than a small amount of cash posted with the RTO for FTRs.

What is the typical collateral threshold amount in your hedging contracts, if there is one? Collateral thresholds vary from \$5 million to \$50 million. The cooperative manages its transactions with various counterparties in order to avoid having to post collateral by keeping exposures to any counterparty below the applicable threshold.

How often is collateral or margin reevaluated and exchanged while a transaction is outstanding? Collateral or margin requirements are calculated daily.

In what form do you post collateral for your hedging transactions? Letters of Credit for OTC transactions; cash for NYMEX transactions.

Approximately what percentage of your hedging contracts involve collateral obligations? None of the OTC hedging contracts currently have collateral obligations.

Bond ratings: Not Rated

Ability of system to raise rates if needed to ensure fiscal stability: The utility has autonomous authority to establish rates charged for all services. Rates are approved annually by the utility's Board of Directors and are not subject to rate regulation by the state public utilities commission. Rates must be sufficient to recover all costs and to meet financial covenants contained in the mortgage with the primary lender, the Rural Utilities Service, and loan agreements with other lenders.

Use of outside advisors:

Consulting services of ACES Power Marketing are used for trading and risk management activities.

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## Public Power Utility in the South Central Region

Region: Southwest Power Pool (SPP) region.

Type of utility: Joint Action Agency (JAA) providing power supply to 37 municipal utilities.

Our Board of Directors is made up of representatives of the cities and municipalities we serve.

Description of customer base: The JAA's member utilities have a projected 2011 peak demand of approximately 743 megawatts (MWs) and total energy requirements of 2,521,000 megawatt-hours (MWHs).

Owned generation: The JAA owns approximately 575 MWs of generating capacity: 120 MWs of coal, 380 MWs of natural gas, 75 MWs of hydro and wind facilities.

Purchased generation and transmission: The JAA has power purchase agreements with other utilities to receive approximately 293 MWs of power. The JAA also has network transmission service agreements with the Southwest Power Pool to ensure delivery of the power. The JAA's financial hedging is in natural gas swaps.

Risk management/hedging policy description: JAA staff can enter into swaps for electricity and fuels for terms of one year or less, as long as the amount is within the generally approved budget, the credit rating of the counterparty is investment grade or better, and the transaction is "matched" by the projected physical requirements of the commodity being hedged. All agreements that are greater than one year or exceed the budget require advance approval of the Board of Directors.

The JAA typically hedges 50 percent or less of the projected May-September volume of natural gas, although specific pre-approved volumes for the entire year can be hedged. The JAA does not typically hedge natural gas volumes more than two years in the future. The purpose of the JAA's natural gas hedges is to lock in a fixed price for the volumes approved.

Recordkeeping procedures: Every transaction is conducted on a recorded telephone line and entered into the JAA's records. The transaction is followed up with a written confirmation executed by both parties in accordance with the underlying ISDA contract. The JAA receives mark-to-market reports from its counterparties at each month-end, and reports monthly to its Board on the amount and volume of hedging transactions.

Types of counterparties: The JAA has ISDA contracts with two bank counterparties, and is in the process of adding contracts with an energy company and another bank.

Types of commodities/products used: Natural gas. All are over-the-counter transactions. None are on CFTC-regulated exchanges. The JAA typically has a 2-year planning horizon.

What happens to gains/losses from these activities: Generally, annual gains/losses would be reflected in the JAA's rates. The financial effect of our hedges is disclosed by footnotes in our financial statements. In all likelihood, for yearend 2010 and forward, the JAA will show a deferred asset on its balance sheet for the net effect of the hedges. Once the hedges are cash settled, the gain/loss is taken against income.

### **Current collateral posting requirements**

What is the typical collateral threshold amount in your hedging contracts, if there is one?

Collateral is determined by the credit rating of the JAA's bonds. It is a sliding scale: the higher the credit rating, the higher the threshold that must be exceeded before margin has to be posted.

How often is collateral or margin reevaluated and exchanged while a transaction is outstanding?

The mark-to-market value on the hedge and the threshold required in the ISDA determines the collateral that would be posted; the mark-to-market value is continuously monitored.

In what form do you post collateral for your hedging transactions? Collateral can be posted in the form of cash, U.S. Treasury obligations, or high-rated commercial paper (rated "A1" by Standard & Poor's or "P1" by Moody's).

Approximately what percentage of your hedging contracts involve collateral obligations?

100% of the JAA's hedges have "threshold" collateral requirements, as previously described. Currently, none of the JAA's hedges exceeds the threshold that would require collateral.

Credit ratings: Rated "A" by Standard & Poor's and A2" by Moody's.

Ability of system to raise rates if needed to ensure fiscal stability: The JAA's Board of Directors has the ability to make a rate change with 60 days notice. The JAA reviews its rates and revenue requirements periodically and will implement rate changes as necessary to comply with its rate covenants.

Use of outside advisors: The JAA does not use outside advisors for its hedging program because it has significant in-house expertise. The JAA's general manager and finance manager have experience with financial management products, including energy derivatives. In addition, the JAA's Board of Directors, which is made up of representatives from the JAA's member cities and municipalities, includes directors with banking and financial management experience. To require the JAA to use outside advisors for its hedging program would add little or nothing to the JAA's ability to structure a hedging program to meet its financial goals and is counter to the JAA's mission of delivering power to customers at a reasonable cost. Instead, it would increase our cost of service in the form of the rates that the JAA passes on to the cities and municipalities that it serves.

## Public Power Utility in California

Region: California The utility purchases services, such as transmission and power, from the California Independent System Operator (CAISO), but its transmission assets are not within the geographic boundaries of the CAISO Region.

Type of utility: Electric municipal utility run by a Board of Directors elected by consumers in its service territory. The utility serves approximately 600,000 customers (population of 1.4 million people).

Description of customer base: Serves approximately 522,000 residential and 79,000 commercial customers. The utility has a peak load of 3,300 megawatts (MWs).

Owned generation and transmission: Generating capacity of 1,000 MWs natural gas, 684 MWs hydro, and 147 MWs wind; 2,000 MWs of import transmission capacity (approximately 500 MW of potential export capacity limited by system resource constraints). To source natural gas for fuel, also owns natural gas reserves of 150 billion cubic feet (BCF), with 25,000 decatherms (DTH)/day production capacity; gas storage of 2.25 BCF.

Purchased generation and transmission: Purchased power contracts totaling approximately 1,100 MWs; long term transmission capacity contracts totaling 624 MWs, with approximately 400 MWs of daily spot market transmission capacity purchases. Also gas transportation contracts on seven pipelines, totaling 130,000 DTH/day in capacity.

Congestion Revenue Right (CRR) holdings to support transmission/power supply transactions: As a load-serving entity (LSE), the utility is eligible to participate in the CAISO CRR market. Similar to financial transmission rights (FTRs) in other regions, CRRs are a financial hedging tool and do not convey any physical transmission rights.

Energy Risk management/hedging policy description: Hedging and commodity procurement activities are closely regulated by the utility's Energy Risk Management and Energy Trading Standards. These documents were developed by the utility's executive management to prohibit activities – such as speculative trading and market manipulation – that could cause financial harm to the utility. Only transactions that pertain to serving electric load or procuring gas supply are allowed, and the sale of uncovered call or put options is specifically prohibited. In addition to these control procedures, staff of the utility's energy trading department must complete annual training to maintain certificates allowing them to trade.

Hedges are procured with the intent of locking the price of the utility's future commodity costs. Once a sufficient share of the future commodity costs are hedged for multiple years forward, the utility's future retail electricity rates are then set to ensure that sufficient revenues are collected to cover these costs. In essence, the retail rate setting process locks the revenues and matches the expected hedged costs. This effort of matching and locking revenues with costs is performed for two-year time blocks. By following this procedure,

the utility is comfortable with a covenant in its ISDA agreements that it will set retail rates sufficient to cover the financial obligations of any hedge transacted under the ISDA.

Recordkeeping procedures: All energy transactions are validated internally on a (business) daily basis by back office function, via logs and cross-system reconciliation. Within days of the end of each month, the utility's energy settlements staff checks out with representatives from each counterparty the utility has transacted with during that month to verify that both parties are in agreement for invoicing. Checking out and invoicing are done on a monthly basis consistent with industry standards, where invoices are issued and payment is due the month following the transactions month.

Types of counterparties: The utility has 20 ISDA counterparties – 14 banks and 6 producer or utility-based trading operations.

Types of commodities/products used: Financial NYMEX natural gas; financial natural gas basis (AECO, Malin, NW Rocky Mountain, Socal); financial power (NP15, Mid-Columbia).

What happens to gains/losses from these activities: Gains or losses from financial hedging activities are netted against physical transactions, which ultimately determine the net commodity cost for the utility.

### **Current collateral posting requirements**

What is the typical collateral threshold amount in your hedging contracts, if there is one? All of the utility's financial hedging contracts are supported with a Credit Support Annex (CSA) to an ISDA contract, and both of these are negotiated between the utility and each individual counterparty. A collateral threshold table, which associates different collateral thresholds with different credit ratings, is applied to all CSAs. Because the utility restricts hedge trading to those counterparties with at least A- credit rating (better than investment grade), the typical collateral threshold is \$20 million. This is the dollar amount the utility is able to manage within its annual budget without having to raise its customers' rates to cover the unsecured credit loss. This \$20 million collateral threshold would be reduced when the utility or the counterparty's credit rating is reduced, per the collateral threshold table.

How often is collateral or margin reevaluated and exchanged while a transaction is outstanding? Mark-to-market values are calculated on a weekly basis, and collateral/margin is transferred weekly. However, if the credit rating for the utility or its counterparty falls below a certain level (pre-determined in the CSA), then collateral/margining becomes daily.

In what form do you post collateral for your hedging transactions? The utility posts letters of credit (LOCs) and cash exclusively. We estimate the breakdown is 50% LOCs and 50% cash. It could also post cash-equivalent assets, but chooses not to do so. The utility cannot and does not post physical assets.

Approximately what percentage of your hedging contracts involve collateral obligations?

All of the utility's financial hedges are backed by an ISDA contract with a CSA that involves the posting of collateral. Some of the utility's large-volume, long-term, physical purchase transactions have deal-specific collateral agreements as well.

Credit ratings: The utility is currently rated "A+" by Standard and Poor's, "A1" by Moody's and "A" by Fitch. It is extremely important to maintain our current ratings levels to ensure full access to credit markets. The utility's ratings are based, in part, on its ability to manage commodity risk, maintain its cash liquidity position and service its overall debt level. Given current market conditions and the scarcity of available bank facilities at a reasonable cost for lines of credit or LOCs, in the short run, any additional collateral posting requirements would force the utility to issue long-term debt to maintain liquidity. In the long run, the utility could not continue to access the long-term debt market to maintain liquidity for collateral postings without degrading its ratings and would have to either raise rates to fund collateral postings, or discontinue its hedging program and rely on additional reserves to provide a cash cushion to account for the risk of fluctuating commodity prices. Under either scenario, the utility's rate payers would face greater costs for energy.

Ability of system to raise rates if needed to ensure fiscal stability: The utility has autonomous authority to establish the rates charged for all services. Unlike investor-owned utilities and some other municipal utility systems, retail rate and revenue levels are not subject to review or regulation by any other governmental agencies, be they federal, State or local. Changes in rates require formal action, after public hearing, by the utility's Board of Directors. The utility is also not required by law to transfer any portion of its collections from customers to any local government.

Use of outside advisors: The utility relies on in-house expertise to manage commodity hedges, but does use an outside financial advisor to oversee the market bidding process on its interest rate hedges to ensure that bids are structured and priced within market parameters.