From: Hamer, Linda <LHamer@mwe.com>
Sent: Monday, November 22, 2010 10:00 PM
To: EndUser <EndUser@CFTC.gov>
Subject: Pre-Rule Proposal Comments of EEI and EPSA
Attach: EEI EPSA Pre-NOPR Letter on End User Exception 11 22 10.pdf

---

Attached please find the pre-rule proposed comments of Edison Electric Institute and Electric Power Supply Association ("Joint Commenters") concerning the end-user clearing exception in Section 723 of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Linda Hamer
McDermott Will & Emery LLP
600 13th Street, N.W.
Washington, D.C. 20005
202.756.8059
lhamer@mwe.com

November 22, 2010

VIA ELECTRONIC SUBMISSION

David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, DC 20581

Re: Pre-Rule Proposal Comments on Issues Related to the End-User Clearing Exception of Edison Electric Institute and Electric Power Supply Association

Dear Mr. Stawick:

The Edison Electric Institute ("EEI") and Electric Power Supply Association ("EPSA") (hereafter "Joint Commenters") respectfully submit these comments concerning the end-user clearing exception in Section 723 of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] Joint Commenters offer these comments in advance of the issuance of any proposed rules related to the end-user clearing exception to provide the Commission with information about the commercial practices of end users and to make several recommendations for the Commission's consideration. Joint Commenters welcome the opportunity to continue to discuss these issues further with the Commission and its staff.

The Dodd-Frank Act reflects Congress' intent to provide end users with broad exemptions from the registration and clearing requirements of the Commodity Exchange Act, as amended ("CEA"). Joint Commenters respectfully submit that, in implementing the requirements of the Dodd-Frank Act, the Commission should take care to ensure that end users are not subjected to regulatory requirements that Congress intended to apply only to swap dealers and major swap participants. The Commission also should ensure that end users and their non-financial affiliates can avail themselves of the end-user clearing exception and the exemption of bona fide hedging transactions from position limits in a commercially practical manner that is consistent with Congress' intent.

---

[1] Pub. L. No. 111-203 (2010).

I. Description of Joint Commenters and Their Interest in the End-User Clearing Exception

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. EEI also has more than 65 international electric companies as Affiliate members, and more than 170 industry suppliers and related organizations as Associate members. EEI's members are not financial entities. Rather, the typical EEI member is a medium-sized electric utility with relatively low leverage and a conservative capital structure.[2]

EPSA is the national trade association representing competitive power suppliers, including generators and marketers. These suppliers, who account for nearly 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities. EPSA seeks to bring the benefits of competition to all power customers.

As end users of commodity swaps to hedge commercial risk, Joint Commenters have a significant interest in how the Commission implements the end-user clearing exception. The way in which the CFTC implements the end-user clearing exception and related provisions will have a direct and substantial impact on how EEI and EPSA members manage their commercial risk. Regulations that make effective risk management options more costly for end users of swaps will likely result in more volatile and increased energy prices for customers.

II. Scope of the End-User Exception

The clearing requirements generally applicable to swaps under the CEA do not apply to a swap if one of the counterparties is what has come to be known as an "end user."[3] Under the Dodd-Frank Act, an end user is a commodity market participant that:

(i) is not a financial entity;[4]
(ii) is using swaps to hedge or mitigate commercial risk; and
(iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps.[5]

---

[2] Many EEI members are subject to substantial state regulatory requirements that impose, among other things, significant leverage limitations.

[3] CEA § 2(h)(1)(A), § 2(h)(8).

[4] Section 2(h)(7)(C) of the CEA provides that, for the purposes of the end-user exception, the term "financial entity" means, in relevant part—

(I) a swap dealer;
(II) a security-based swap dealer;
(III) a major swap participant;
(IV) a major security-based swap participant; . . .
(VIII) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956. *Id.*

Congress provided end users with the option not to clear swaps that they use to hedge commercial risk because end users need access to cost-effective risk management tools and have an established track record of using these tools in a manner that *reduces* systemic risk.[6] Consistent with Congress's intent, the Commission should propose rules that provide end users and their non-financial affiliates with ready access to the end-user clearing exception. A broad end-user exception will preserve the current efficiency of the commodity markets by preventing the introduction of unnecessary transaction costs and, importantly, allow end users to continue to protect their customers from higher and more volatile prices.

III. The Commission Should Define "Swap Dealer" and "Major Swap Participant" in a Manner that Will Allow End Users and Their Non-Financial Affiliates to Utilize the End-User Exception

Joint Commenters individually submitted comments earlier this fall to the Commission in response to the Advance Notice of Proposed Rulemaking regarding key definitions contained in the Dodd-Frank Act, including the definition of "swap dealer" and "major swap participant." As explained in these filings, Joint Commenters urge the Commission to take great care in defining the entities that will be regulated as swap dealers and major swap participants. If these terms are defined too broadly, end users and their non-financial affiliates may be subject to numerous regulatory requirements, including mandatory clearing, that are inconsistent with Congress's intent and unwarranted for end users. For these reasons, Joint Commenters respectfully request that the Commission define "swap dealer," "major swap participant," and other key definitional terms in a manner that allows end users to except their swap hedging transactions from mandatory clearing, whether they enter into hedging transactions directly or through an energy marketing affiliate.

IV. The Commission Should Implement a Commercially Practical End-User Clearing Exception

A commercially practical end-user clearing exception has two basic requirements: a broad and consistent definition of commercial risk; and sufficient flexibility to accommodate the variety of ways in which end users hedge their commercial risks.

A. The Commission Should Define "Commercial Risk" Broadly and Consistently Throughout the CEA

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." Without a definition of commercial risk, the end-user clearing

---

[5] Dodd-Frank Act § 723(a)(3) (to be codified as CEA Section 2(h)).

[6] As Rep. Colin Peterson explained on the House floor, "[Congress] 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." 156 Cong. Rec. H5245 (daily ed. Jun 30, 2010) (statement of Rep. Peterson).

exception (and other important provisions of the Dodd-Frank Act) will be ambiguous. The Commission should propose a definition of "commercial risk" that is broad enough to accommodate the risk-management activities of many different commercial enterprises. Joint Commenters respectfully suggest that the Commission define commercial risk as follows:

> ***Commercial Risk.*** This term means any risk that a person or governmental entity[7] 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 risk; liquidity risk; financial statement risk; and any other risk that can be hedged or mitigated with a swap.

For the Commission's reference, we have attached to this letter, as Attachment A, several examples of how end users in the energy industry, including EEI and EPSA members, may use swaps to hedge various types of commercial risk, including market, credit, operating, and liquidity risk.

In addition, 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.[8] Joint Commenters are not aware of any information which suggests that Congress intended the meaning of the term "commercial risk" to vary depending upon where it appears in the CEA.

As a practical matter, a single definition of commercial risk is necessary to provide consistency and clarity to the multiple provisions of the CEA and the Commission's implementing regulations that refer to or depend on the meaning of the term.[9] A consistent definition of commercial risk will promote a coherent and commercially practicable regulatory system that promotes compliance rather than confusion. If, for example, commercial risk is defined more broadly for the purpose of the end-user exception than for the definition of major swap participant, companies could face the following "Catch-22": a company 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

---

[7] "Governmental entity" is defined within the definition of "eligible contract participant" generally as including: (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). CEA § 1a(12).

[8] *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.").

[9] Dodd-Frank Act § 721(a) (to be codified as CEA § 1a(19) (definition of "excluded commodity")); *Id. at* § 721(a) (to be codified as CEA § 1a(33) (definition of "major swap participant")); *Id.* at § 723(a) (to be codified as CEA § 2(h)(7)(A) (general requirements of the end-user clearing exception)); *Id.* at § 723(a) (to be codified as CEA § 2(h)(7)(D) (treatment of affiliates under the end-user clearing exception)).

unreasonable result that can easily be avoided by employing a consistent definition of commercial risk throughout the CEA

B. The End-User Exception Should Be Flexible Enough to Accommodate the Many Different Ways that End Users Hedge Commercial Risk

Congress made clear that it did "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."[10] The fulfillment of Congress's express intent that the clearing requirement not be applied to end-user hedging should not be conditioned on how the end user has structured its business. Rather, the exception should be interpreted in a commercially practicable way that allows end users to continue to manage their commercial risk under the Dodd-Frank Act with minimal disruption to their existing commercial activities, however they are structured.

End users manage their commercial risk in many different ways. For example, one end user may manage its hedging activities on its own; while the next end user might use a centralized hedging affiliate to execute and manage all hedges; while yet another end user might use multiple hedging affiliates to execute different types of hedges. When hedging through an affiliate, an end user may enter into a swap with its affiliate (which then enters into another back-to-back trade with an unaffiliated third party) or it may use its affiliate as an agent. Regardless of how the end user's business or particular hedging transactions are structured, in each of these cases the end user is hedging or mitigating its commercial risk. These varied approaches to risk management achieve the same results. They reduce transaction costs, increase operating efficiency, and minimize the net exposure that affiliated companies need to hedge in the futures and swaps markets, all without increasing systemic risk.

The Commission should clarify that the end-user exception is available to any end user that is using swaps to hedge or mitigate commercial risk regardless of whether it hedges its risk directly or through an affiliated entity. Section 2(h)(D)(i) of the CEA provides that "[a]n affiliate of a person that qualifies for [the end user exception] … may qualify for the exception only if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity."[11] The Commission should clarify that "acting on behalf of the [end user] and as an agent" to hedge or mitigate commercial risk includes inter-affiliate transactions.[12] Without this clarification, the end-user exception may not accommodate the different ways that many end users actually hedge and mitigate their commercial risk.

---

[10] 156 Cong. Rec. H5248 (daily ed. June 30, 2010) (Dodd-Lincoln Letter).

[11] The Commission also should clarify that an end user that is eligible for the clearing (and, therefore, exchange trading) exception is also exempt from the exchange trading requirement pursuant to Section 2(e) of the CEA, as amended, for swaps that are used to hedge or mitigate the end user's commercial risk.

[12] If Congress considered it appropriate to exempt inter-affiliate swaps within financial entities, it is also appropriate to exempt inter-affiliate swaps used by end users to hedge or mitigate commercial risk. *See* 156 Cong. Rec. S. 5921 (daily ed. July 15, 2010) (statement of Sen. Lincoln) (noting that it would be appropriate to except from the clearing requirement financial entities' inter-affiliate swaps).

V. The Commission Should Propose a Commercially Practicable "Notification" for End Users to Apprise the Commission of How They Generally Meet Their Financial Obligations Associated with Entering into Non-Cleared Swaps

Section 2(h)(7)(A)(iii) of the CEA requires an end user that elects not to clear swaps or trade swaps on an exchange to notify the Commission as to how it "*generally* meets its financial obligations associated with entering into non-cleared swaps."[13] It also allows the Commission to specify the ways in which end users may satisfy this general notice requirement.[14] Joint Commenters urge the Commission to propose a rule which establishes a simple and flexible notification procedure that avoids placing any undue burden on end users. A notification requirement that requires frequent, detailed submissions to the Commission would be inconsistent with the language of the statute and would impose significant operational burdens on end users and, ultimately, unnecessary costs for their customers.

A. Timing of the CFTC "Notification"

The Commission should consider permitting end users to submit a one-time notice concerning how the end user generally meets its financial obligations on non-cleared swaps, coupled with an obligation to notify the CFTC of any material change to the information in the notice. The obligation to notify the Commission of any material changes will ensure that the Commission receives timely information about how an end user generally meets its obligations under its non-cleared swaps. Such a notice requirement would impose a minimal burden on end users, without compromising the Commission's access to accurate and timely information regarding the financial practices of the counterparties to non-cleared swaps. If the Commission elects to require some form of mandatory periodic notification, it should be at most an annual notification. The end-user clearing exception only requires end users to notify the Commission about how they "generally" meet their financial obligations on non-cleared swaps. End users should not be required to submit a notice when each new counterparty relationship is established or following every new transaction. Repetitive notice requirements would impose a significant burden on end users, and would not provide the CFTC with any new information regarding how an end user generally meets its financial obligations on non-cleared swaps.

B. Form and Content of the CFTC "Notification"

The Commission should provide end users with reasonable discretion concerning how to comply with the notice requirement. As the corporate structures and financial information maintained by the many types of end users differ considerably, Joint Commenters believe that it is important for the Commission to be flexible regarding the type of general information (particularly financial information) that it considers requiring an end user to provide with its notification. For example, smaller end users may maintain only basic information about their finances, while larger end users may maintain detailed audited financial statements.

---

13 Dodd-Frank Act § 723(a)(3) (to be codified as CEA § 2(h)) (emphasis added).

14 *Id.*

Joint Commenters recommend that, rather than prescribing the exact type and form of information to be included in a notification, the Commission accept as notification a concise description of an end user's credit and contracting practices, which could include its risk management policies, collateral arrangements and access to funding. An obligation to notify the Commission of any material change, coupled with such a description, will ensure that the Commission has sufficient information about how an end user is generally able to meet its obligations under its non-cleared swaps. Regardless of the manner in which the required notification is made, the Commission should treat the notice (and any non-public information contained with or within the notice) as confidential to protect the proprietary nature of each end user's business.[15]

VI. The Commission Should Establish Prudential Rules Regarding the Segregation of Collateral for Non-Cleared Swaps

Section 4s(l) of the CEA provides that, upon request, swap dealers and major swap participants must segregate certain funds or other property supplied to margin, guarantee, or secure the counterparty's obligations with respect to a non-cleared swap.[16] Although Section 4s(l) generally requires any segregated collateral to be maintained in an account carried by an independent third-party custodian, Section 4s(l)(2)(ii) specifically permits other "commercial arrangements" for the investment of segregated funds or other property (as permitted by the CFTC).[17]

In implementing this provision, the Commission should clarify that an end user and its counterparty are allowed to negotiate the terms that will govern the treatment of the segregated collateral. Similarly, the CFTC should not impose mandatory margin requirements on swaps in which one counterparty is an end user. Instead, consistent with Congress's intent, the Commission should allow the parties to negotiate mutually agreeable margin and collateral requirements.[18] Accordingly, an end user should be permitted to freely negotiate what margining provisions, if any, will apply to its non-cleared swaps, even if its counterparty is a swap dealer or major swap participant.

---

15 The Commission should consider adopting a provision here similar to the one it already has in Section 8(a)(1) of the CEA concerning the CFTC's investigational authority, which provides that the Commission "may not publish data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers."

16 Dodd-Frank Act § 724 (to be codified as CEA § 4s(l). Section 4s(l) does not apply to variation margin.

17 *Id.*

18 *See* 156 Cong. Rec. H5248 (daily ed. June 30, 2010) (statement of Rep. Peterson and Dodd-Lincoln Letter) ("[W]e have given the regulators no authority to impose margin requirements on anyone who is not a swap dealer or a major swap participant.).

VII. Conclusion

Joint Commenters commend the Commission for its commitment to safeguarding the hedging and trading activities of end users of swaps, and look forward to continuing to work with the Commission throughout the Dodd-Frank Act rulemaking process. As explained herein, we encourage the Commission to ensure that end users and their non-financial affiliates can avail themselves of the end-user clearing exception and are exempted from regulatory requirements that Congress intended to apply only to swap dealers and major swap participants.

Please contact us if you have any questions regarding these comments.

Respectfully submitted,

Richard F. McMahon, Jr.
Executive Director
Edison Electric Institute
701 Pennsylvania Avenue, N.W.
Washington, DC 20004
Phone: (202) 508-5571
Email: rmcmahon@eei.org

/s/

Dan Dolan
Vice President, Policy Research & Communications
Electric Power Supply Association
1401 New York Ave., NW 11th Floor
Washington, DC 20005
Phone: (202) 349-0153
Email: ddolan@epsa.org

Examples of Commercial Risk

Definition of Commercial Risk proposed by EEI:

> ***Commercial Risk.*** This term means any risk that a person or governmental entity[1] 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 risk; liquidity risk; financial statement risk; and any other risk that can be hedged or mitigated with a swap.

1. Market Risk. Party A,[2] a generator, has an electricity load obligation (*i.e.*, a commitment to supply electricity) for calendar year 2011. To mitigate its exposure to volatile fuel commodity prices, Party A's marketing affiliate enters into a fixed-for-floating swap in which the marketing affiliate pays a fixed price, and receives the average spot market price, for natural gas on each settlement date during the term of the swap. Party A buys physical gas on the spot market to meet its load obligation. The financially-settled swap permits Party A through its marketing affiliate to reduce the price risk associated with the purchase of physical gas.

2. Credit Risk. Party A entered into a long-term physical gas transaction with Party B in early 2009. Party B is now in financial distress, and Party A is concerned that Party B may fail to deliver. Regardless of whether Party B performs, Party A must supply fuel to its generating facilities. Party A enters into a swaption that gives Party A the right to enter into a fixed-for-floating swap, as in the example above, in which it would pay a fixed price and receive the average spot market price for natural gas. Party A may exercise the swaption if Party B defaults on its obligation to deliver natural gas.

3. Operating Risk. Party A sells the output of its generating unit on a "firm basis" to Party B. This means that Party A has committed to provide a certain amount of generating capacity and electricity to Party B, regardless of any maintenance required by the unit. At the outset of the contract term, Party A enters into a swaption (see example 2) to enter into a fixed-for-floating swap based on the average spot market price for physical power in case the unit requires unexpected maintenance.

---

[1] "Governmental entity" is defined within the definition of "eligible contract participant" generally as including: (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). CEA § 1a(12).

[2] For purposes of these examples, Party A is an end user

Early in the term of the contract, Party B starts and runs the unit more than Party A anticipated. The higher than anticipated usage requires Party A to schedule the unit for a long-term maintenance outage during an upcoming peak period. Party A exercises the swaption, thereby entering into a fixed-for-floating swap in which it pays a fixed price and receives the average spot market price for electricity. Party A also buys physical power on the spot market to meet its commitment to Party B. The swaption mitigates Party A's exposure to price spikes during the maintenance period.

4. Liquidity Risk. Party A, which has a strong balance sheet and cash flows and a relatively low-risk business profile, has committed to purchase power from Party B pursuant to a physical power purchase and sale agreement ("Agreement"). Party A desires to hedge the risk associated with its commitment.

   To establish a hedge that is efficient from the perspective of Party A's cash flows and liquidity, Party A enters into a non-cleared, bilateral swap in which its counterparty extends it a certain level of unsecured credit, up to a negotiated threshold amount, based on Party A's financial strength and the nature of its business.

   If Party A hedged the same risk on an exchange, it would be subject to initial and variation margin requirements that would not match the credit terms of its physical power purchase agreement, which does not allow for margining by either Party A or Party B. Accordingly, if Party A entered into the hedge on an exchange, it would face liquidity risk in that (1) it could be required to post an uncertain (and potentially large) amount of variation margin if the price of power moved substantially during the term of the Agreement and the associated hedge, but (2) Party A would be entitled to receive no margin from Party B under the Agreement.

   To avoid this mismatch and risks to its working and investment capital, Party A will best utilize its strong credit by entering into a non-cleared bilateral swap with a counterparty that has extended a certain level of earned, unsecured credit to Party A.