



September 20, 2010

**Via Email: [dfdefinitions@cftc.gov](mailto:dfdefinitions@cftc.gov); [Secretary@CFTC.gov](mailto:Secretary@CFTC.gov)**

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

**Re: Advanced Notice of Proposed Rulemaking Comments on Key Definitions; Comment File 10-012**

Dear Mr. Stawick:

The Electric Power Supply Association (“EPSA”) submits this letter in response to the Advanced Notice of Proposed Rulemaking (“ANOPR”) issued by the Commodity Futures Trading Commission (the “CFTC” or the “Commission”) on key definitions of Major Swap Participant (“MSP”), Swap Dealer and Swap.<sup>1</sup> This rulemaking is part of the Commission’s implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”).<sup>2</sup>

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

EPSA was an active participant in discussions with legislators on the development of Title VII of the Act and appreciates that Title VII contains an exception from clearing requirements for a swap if one of the swap counterparties: (1) is not a financial entity; (2) is using swaps to hedge or mitigate commercial risk; and (3) notifies the CFTC, in a manner set forth by the CFTC, how it generally meets its financial obligations associated with entering into non-cleared swaps. This exception applies to

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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 position of EPSA as an organization, but not necessarily the views of any particular member with respect to any issue.

competitive power suppliers involved in the generation, marketing and retailing of power – and would allow for cost-effective risk management. These over-the-counter (“OTC”) risk management tools have been used long before consideration of the Act, allowing power suppliers to hedge against uncertainties such as the fluctuating prices of commodities used as fuel to generate electricity.

For the purposes of this letter, all parties fitting this exemption will be referred to as “commercial end-users,” consistent with the term “end-users” used throughout the legislative history of the Act, and in a letter written by the principal Senate authors of the Act’s Title VII, Chairman Christopher J. Dodd and Chairman Blanche Lincoln.<sup>3</sup> The letter clearly states the intent of the MSP and Swap Dealer categories, “In implementing the Swap Dealer and Major Swap Participant provisions, Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participants 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.”<sup>4</sup>

## **Introduction**

It is clear from the legislative language and the stated intent of Congress that commercial end-users should not be captured as either an MSP or Swap Dealer. Preserving this intent is critical not only because it is what Congress directed but also because it will ensure that competitive power suppliers continue to have the maximum ability to invest in cleaner energy infrastructure, provide affordable energy to consumers and maintain the overall long-term reliability of the electricity system.

Throughout the legislative debate it was broadly recognized that commercial end-users who have an underlying physical business do not create systemic risk to the economy and should be able to continue to manage their commercial risks in the OTC markets. End-users, after all, are the group for which an exception to mandatory clearing was specifically written. As such, the definitions of MSP and Swap Dealer must be implemented in a way that captures financial entities, for which they are intended, while not casting such a wide net as to also include entities whose primary purpose in the derivatives markets is to manage their commercial risks.

EPSA recognizes that financial entities have varying lines of business and may not be an MSP or Swap Dealer in every instance. It is appropriate for the Commission, the Securities and Exchange Commission and the various prudential regulators to look at the totality of a financial entity’s business to determine when and where they are

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<sup>3</sup> Letter from Chairman Christopher J. Dodd, Senate Committee on Banking, Housing and Urban Affairs and Chairman Blanche Lincoln, Senate Committee on Agriculture, Nutrition and Forestry to Chairman Barney Frank, House Committee on Financial Services and Chairman Colin Peterson, House Committee on Agriculture, at 2 (June 30, 2010) (“Dodd-Lincoln Letter”).

<sup>4</sup> Dodd-Lincoln Letter at 3.

acting as end-users versus some other defined role (e.g., Futures Commission Merchant, MSP, Swap Dealer, etc.). In contrast, the Commission should start with the presumption that every competitive power supplier is not an MSP or Swap Dealer and should maintain that presumption absent clear evidence that supports an individualized finding to the contrary. The focus on those with the greatest potential for creating systemic risk in the economy is key and should be kept in mind as the Commission implements the MSP and Swap Dealer definitions.

### **Definition of Major Swap Participant**

To be an MSP, an organization would need to either (1) hold outstanding swaps that create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets or (2) have a substantial position in swaps after excluding all positions held for hedging or mitigating commercial risk.<sup>5</sup> These prongs of the MSP definition should be implemented to comport with clear Congressional intent and appropriately recognize the role of physical energy end-users in the derivatives markets. EPSA members do not pose a systemic risk to the overall financial system or economy and should thus not be designated as MSPs.

In the first instance, EPSA's members do not create substantial counterparty exposure that could jeopardize the U.S. financial markets or banking system. Based on the public record, there is no evidence that energy commodities and energy-related derivatives played any role in the recent financial crisis or historically had any material impact on the financial markets or banking specifically, or otherwise created systemic risk generally. Indeed, the energy markets have been able to absorb significant participant defaults and market exits with little disruption, including the collapse of banking entities and large commodity market participants. Furthermore, there is no obvious connection between the U.S. financial markets/banking system and the energy commodities and derivative markets. If the Commission believes that a commercial end-user's swaps are somehow materially interconnected to the financial system, the Commission should logically have to support such a position with detailed empirical evidence.

A "Substantial Position" is explicitly linked in the Act to the monitoring and oversight of systemically important entities to swaps and financial markets. Meaningful monitoring of such entities will no doubt place the threshold of such a position at a material quantity of swaps with financial risk (as the definition also requires analysis of collateral and other credit related items). The mere possession of uncleared swaps that are not used to hedge commercial risk is inadequate to amount to a substantial position. EPSA understands that the Financial Stability Oversight Council will ultimately determine which entities merit monitoring due to posing systematic risk.<sup>6</sup> We do not

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<sup>5</sup> 7 U.S.C. § 1(a)(33)(A)(i) and (ii). Section 1(a)(33)(A)(iii) applies to financial entities.

<sup>6</sup> See Act, Public Law No: 111-203 Sections 112 and 113.

expect that list to include competitive power suppliers. Nevertheless, no measure of a Substantial Position can be constructed without reference to the monitoring and oversight of systemically risky financial entities. Accordingly, EPSA urges the Commission to avoid “putting the cart before the horse,” and defining Substantial Position out of context of its statutory purpose.

With regards to determining whether a market participant has a substantial position, the Act expressly requires the Commission to exclude positions used to hedge or mitigate commercial risk.<sup>7</sup> In other words, to be an MSP, a market participant would have to have a substantial speculative position in a particular uncleared swap. Such an outcome is further supported by the way the Act differentiates between cleared and uncleared transactions. Congress decided that end-users do not have to clear swaps because they largely use such transactions for hedging. For the same reason, the definition of substantial position should only reflect non-hedged, non-cleared transactions.

Additionally, Congress directed the Commissions to define the term “substantial position” at “the threshold that the Commission[s] determine 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.”<sup>8</sup> Therefore, the definition of substantial position should be tailored appropriately to only capture those entities that pose the largest risk to the economy (e.g., financial entity swap positions that create systemic risk because of the nature of the company holding the position, the position size, speculative trades versus hedges, etc.). The lone remaining task is to define what constitutes commercial risk within the boundaries Congress established.

EPSA recommends that “commercial risk” includes the full variety of risks that end-users have managed historically, or may come to manage in the future, and for which exchanged-traded and OTC products can offset some or all of the effects of such risks. To facilitate the Commission’s consideration, we propose the following definition:

**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 risk; liquidity risk; financial statement risk; and any other risk that can be hedged or mitigated with a swap.<sup>9</sup>

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<sup>7</sup> *Id.* (An MSP “[m]aintains a substantial position in swaps ... excluding--(I) Positions held for hedging or mitigating commercial risk.”).

<sup>8</sup> 7 U.S.C. § 1(a)(33)(B).

<sup>9</sup> Hedging and mitigating commercial risk does not include any activity undertaken to assume the risk of changes in the value of a commodity.

EPSA supports this definition because it focuses on the economic risks that a physical energy company can hedge with swaps in the day-to-day operation of their business.<sup>10</sup> For example, it is clear that power generators and marketers have and need to continue to be able to manage the risks associated with fuel supply, whether it is risks related to price volatility, default, or delivery. The same is true for power marketing, equipment procurement, commodity conversion, environmental compliance, project development and other activities common to EPSA members and other energy companies in the U.S. The proposed definition of Commercial Risk covers these types of activities and would exclude any OTC hedge of such risk from the positions that could trigger a finding that a Person is an MSP. In addition, this definition should only apply to those entities that are clearly not primarily financial. The Act clearly directs that the definition of commercial risk should only cover those entities that are primarily physical in nature.

The definition of an MSP also must take into account the nature of an entity's position may change over time. Intermittent positions that may appear to be speculative should not override the fundamental presumption that an end-user is not an MSP and that its swaps are used to manage Commercial Risk. EPSA's concern here is that its members periodically may have OTC positions that are created as a hedge but may later appear to be a speculative position or vice versa. For example, an energy company may enter into a swap to hedge some or all of a contract that is under negotiation. The company might take this early position because prices are competitive or to put in place a hedge before the market learns that it has exposure. Energy companies treat this as a hedge of the risk associated with the contract under negotiation but it might be misconstrued to be a speculative position until the contract is actually signed. In any case, such a position should not make the end-user an MSP.

Consistent with the above, any interpretation of what constitutes a "substantial position" or "substantial counterparty exposure" must be structured to include only those systemically important institutions, while recognizing that energy commodity derivatives do not pose the same level of risk as other derivatives and neither do energy end-users. Systemic risk exists when, due to its size and interconnectedness, the failure of a company could cause the collapse of an entire system (a.k.a. too big to fail). As stated above, the energy industry has had its share of market participants facing bankruptcy. What those incidents demonstrate is that the energy markets are adequately diversified and competitive, thereby causing the failure of one to have minimal impact on the energy system as a whole.

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<sup>10</sup> EPSA is not intending to imply that there are readily available swaps that might bear names that match each category of Commercial Risk, such as "liquidity," "regulatory" or "legal risk" swap. Instead, end-users may use any number of commonly-available or to-be-developed swaps (e.g., an energy or interest rate swap), either alone or in conjunction with robust contract terms and other risk management tools, to manage some or all of the enumerated Commercial Risks.

## Definition of Swap Dealer

The Act's definition of a Swap Dealer is written to capture those entities that are clearly market makers and whose core business revolves around dealing swaps.<sup>11</sup> It was plainly Congress' intent not to include end-users, who primarily enter into swaps to manage their commercial risks. The definition should be limited to include those entities that are actively and continuously in the Swap Dealer business as a fundamental part of their business model, such as those who conduct intermediation with customers in the ordinary course of business and are routinely willing and able to take either side of a swap as a service to those customers. Physical energy companies like EPSA's members that are in the electricity supply business do not fit this definition.<sup>12</sup>

A competitive power supplier is primarily a hedger in commodity derivatives, engaging in swaps transactions in order to manage its underlying business risks associated with a physical commodity. In contrast, a dealer will take the opposite side of a swap transaction with a customer as a service to that customer and as part of its core business. The dealer will typically "flatten" the position incurred in the transaction with the end-user via an offsetting swap or futures transaction, so is usually indifferent as to whether it is going long or short. The focus for the Swap Dealer definition should consistently remain those entities that are clearly "two-way" market makers who are indifferent as to whether they are going long or short and whose core business revolves around dealing swaps, the intended targets of the definition of a Swap Dealer.<sup>13</sup>

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<sup>11</sup> 7 U.S.C. § 1(a)(49)(A).

<sup>12</sup> An end-user, or its affiliate, that uses swaps to hedge or mitigate the end-user or affiliate's commercial risk also should be excluded from the definition of a Swap Dealer because such activity does not constitute entering into swaps in the ordinary course of business for purposes of making a market.

<sup>13</sup> The fact that a person is willing to either buy or sell a commodity swap at the same time is not sufficient to treat such an entity as "making a market." For example, owners of electric generating assets often manage price risk associated with future sales and purchases 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 modeled 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. For 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>13</sup> and (2) selling power into the market when the market price is higher than its marginal cost saved to decrease production. As a direct result of its marginal cost curve, an entity that owns generating assets and has variable demand obligations is commonly willing to "buy low and sell high," or to quote a bid-ask spread, to optimize the value of its assets. Thus, in order to protect their retail customers against volatile prices, EPSA'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 prudent use of derivatives should not cause energy companies to fall within the definition of swap dealer.

The Commission has recognized the unique nature of dealing activities, including as recently as July 2010 in its Traders in Financial Futures (TFF) report. The TFF report separates large traders into four classifications, one of which is “Dealer/Intermediary.” In describing the Dealer/Intermediary, the Commission states that such entities “design and sell various financial assets to clients,” and that they “tend to have matched books or offset their risks across markets and clients.” Again, EPSA’s members fall outside this description.

The Act also provides for a “De Minimis Exception” for those end-users who engage in a limited amount of swap dealing with customers.<sup>14</sup> This exception is important as some end-users may occasionally provide services with certain dealer attributes for other end-users; for example, acting as a counterparty to a financial hedge as an “add-on” service to a large physical commodity customer. This activity, however, represents a fraction of their overall business activity and therefore should not cause a physical energy company, primarily in the market to manage its commercial risks, to be designated as a “Swap Dealer.”

### **Definition of Swap**

With respect to the definition of a “swap,” the Commission should not include transactions that anticipate physical delivery but which are ultimately financially-settled in the definition of a regulated swap. Including in the definition of a regulated swap those end-user transactions that are financially-settled would severely limit the ability of certain end-users, like competitive power suppliers, to manage their risks. For example, end-users would be burdened with new direct and indirect regulatory and commercial costs that would make traditional hedges less attractive. Such burdens also could lead to fewer risk management choices available in the market, as end-user counterparties try to reduce their own costs.

The Commission should use care not to characterize traditional forward power and other energy products as swaps. For example, end-users will often enter into binding physical forward transactions, but, for example, may, together with their counterparty subsequently agree to settle or “book-out” their delivery obligations financially to minimize delivery-related expenses. Classifying these forward transactions as “swaps” would be inappropriate by virtue of the fact that the parties entered into a binding transaction that requires physical delivery and receipt which cannot be unilaterally be modified by either party. Parties to these transactions must be prepared to consummate a physical transaction and their counterparty will require performance. It is only upon later circumstances that such a transaction is booked-out.

Transactions that contain an option for physical delivery upon execution also should be excluded. For example, a power marketing company may enter into a transaction to purchase the capacity of a power plant, with a call option giving the purchaser the right (but not the obligation) to require the seller to deliver energy from

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<sup>14</sup> 7 U.S.C. § 1(a)(49)(D).

the plant at a specified price at any time during the term specified in the transaction. If the power marketer never exercises its call rights, it arguably has made a payment with no resulting physical delivery of a product. But during any day specified in the transaction, the buyer had the right to call for physical delivery of energy, and this right to enforce delivery of physical power should exclude the transaction from the definition of a Swap. These structures provide end-users valuable tools for managing price and volume uncertainties, particularly in electricity markets which can experience significant fluctuations in price each hour. The spirit of the transaction is physical delivery when the option is exercised. That is, the end-user that purchases the physical option really needs delivery of the commodity under the circumstances when the option is exercised, but not under the circumstances when the option is not exercised. If the end-user's needs could be satisfied by financial settlement, the end-user could have bought a financial option not a physical option.

Simply stated, Swaps are not physical energy transactions, whether such transactions take the form of tolling agreements, power purchase agreements with a demand charge with dispatch rights or are conducted in an independent system operator or regional transmission organization market. Swaps are financially settling transactions which typically take the form of a fixed for floating transaction where one party pays the other a fixed payment and the other party pays a floating payment (typically based upon an index) with only a net payment changing hands. In no event should any physical energy transaction be considered a "swap."

## **Conclusion**

EPSA strongly encourages the Commission to follow the plain meaning of the legislative language and clear Congressional intent by implementing definitions of MSP and Swap Dealer that capture those systemically important financial entities and positions, while excluding those who use swaps to hedge or manage the commercial risks associated with their business. The MSP definition must be written to capture those entities that create a systemic risk to the economy at large. Swap Dealers are those who primarily are in the business of taking either side of a swap and are clearly dealers. The definition of Swap should also not unnecessarily cast such a wide net as to harm the continued use of OTC commercial transactions that manage risk. The focus on all of these issues must be on financial entities, recognizing that physical energy companies, like competitive power suppliers, should continue to have cost-effective access to OTC risk management tools.

Finally, EPSA believes it is important for the Commission to take into account that it has many oversight tools available (e.g., reporting, enforcement, clearing, position limits, etc.) that will allow it to intercede if one party or position becomes substantial. It need not draft definitions that have the effect of making every market participant an MSP or Swap Dealer when more targeted options are sufficient. These definitions must be written with caution to properly categorize financial entities while allowing commercial entities continued access to OTC markets.

Respectfully Submitted,



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