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CFTC Actions The Energy Industry Should Look For In 2015

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It has been almost five years since Congress enacted the Dodd-Frank Act which provided the U.S. Commodity Futures Trading Commission with oversight over the vast majority of the over-the-counter swaps market. The CFTC, which also has jurisdiction over other derivatives, such as futures and options, has spent that time and significant resources promulgating rules and issuing staff interpretations and no-action relief to implement Dodd-Frank's new requirements. The result is a patchwork of rules and guidance that has had significant direct and indirect effects on the ways energy market participants engage in physical commodity transactions and hedge their risks using derivatives.

While commercial end users, a category that includes most energy companies, were not the intended targets of Dodd-Frank, they are nonetheless subject to many of the requirements implemented under the law, even in instances where the applicability of certain requirements may not be intuitive or make a lot of sense. This is because most energy companies rely on derivatives and other complex financial products to hedge against the inherent risks and volatility associated with participating in commodity markets. But properly managing these risks not only helps the markets, it helps the customers that energy companies serve.

The CFTC's Dodd-Frank implementing rules that have already been finalized have had a significant impact on the way energy companies conduct their business. However, certain rules, including those related to position limits and margin and capital requirements, are still outstanding and could have important ramifications down the road for energy companies and their affiliate companies that participate in the derivatives and physical commodity markets. Further, several of the final rules and interpretations, including those regarding the classification of supply contracts with embedded volumetric optionality and certain reporting requirements, require additional clarity or adjustment to ensure that market participants understand their obligations and that they work for both the regulators and the overall market.

Classification of Supply Contracts With Embedded Volumetric Optionality

Many contracts for the supply of a physical commodity, such as electricity or natural gas, include embedded volumetric optionality provisions that allow energy companies to meet varying demand

while protecting against physical supply risk for a particular commodity. Since 2012, energy companies have needed to evaluate whether such contracts should be classified as a forward contract, trade option or swap in accordance with guidance that the CFTC provided in its 2012 rule that, among other things, further defined the term "swap." This 2012 rule requires that, for a supply contract with embedded volumetric optionality to qualify for the "forward contract exclusion" and be exempt from the CFTC's swap regulations, the facts and circumstances of the contract must satisfy a seven-part, safe harbor analysis.

This seven-part test is complicated and has caused market participants significant confusion. This confusion has, in some instances, resulted in different entities classifying the same types of contracts differently based on their interpretation of the scope of the test. The energy industry has been especially conflicted over the seventh part of the analysis and how contracts that permit nominal delivery, such as peaking supply contracts, should be treated under the test.

In an attempt to clarify its intent concerning forward contracts with embedded volumetric optionality, the CFTC in November 2014 issued a proposed interpretation of how these contracts should be classified by providing further clarification to the seven-part, safe harbor analysis. While this proposed interpretation is somewhat helpful in clearing up some of the uncertainty surrounding the seventh part of the analysis, some questions remain. For example, the CFTC's revisions to the seventh part of the test still restrict the safe harbor's applicability to instances where the embedded volumetric optionality is based primarily "on physical factors or regulatory requirements." However, there are a number of other factors that an entity may consider when deciding to include volumetric optionality provisions in a supply contract, such as the price of the physical commodity. As a result, determining whether the embedded volumetric optionality is based primarily "on physical factors or regulatory requirements" can prove difficult and lead to uncertainty and disagreement among counterparties. In addition, the proposed interpretation does not address how products with nominal delivery should be treated.

In general, supply contracts with embedded volumetric optionality that fail the seven-part test (and that do not qualify for one of the other enumerated exemptions included in the 2012 swap definition rule) would be considered "swaps." However, the CFTC has explained that such contracts may qualify as a subset of swaps known as "trade options," which would provide relief from many of the CFTC's rules pertaining to "swaps." In addition to limited reporting requirements, trade options could still become subject to position limits, margin requirements and potentially other requirements.

In the coming months, in addition to finalizing its interpretation on the seven-part test described above, the CFTC is likely also to provide some additional clarifications to its 2012 interim final rule that described its approach for trade options, in order to provide the industry with more certainty surrounding the applicability of the CFTC's swap regulations to these types of contracts.

Notwithstanding these clarifications from the CFTC, energy companies will still need to stand ready to evaluate and monitor their supply contracts to determine whether they comply with the seven-part test and, if not, whether they qualify as trade options.

Position Limits and Aggregation

The CFTC reproposed its position limits rule in November 2013. In its current form, this reproposed rule would set limits on speculative positions in 28 physical commodity contracts and their "economically equivalent" futures, options and swaps, including four energy contracts: (1) NYMEX Henry Hub Natural Gas (NG); (2) NYMEX Light Sweet Crude Oil (CL); (3) NYMEX RBOB Gasoline (RB); and (4) NYMEX NY

Harbor ULSD (HO). Notably, the reproposed rule does not include limits on electricity and other energy commodities, although the CFTC has said that it expects to issue limits on these commodities in future rulemakings.

The energy industry has expressed many concerns that the reproposed rule, like the original position limits rule that was finalized but then subsequently vacated by the U.S. District Court for the District of Columbia, does not adequately address how energy firms manage risk. In particular, the reproposal narrows the scope of the bona fide hedging exemption to only apply to specifically enumerated hedging transactions, which may make it more difficult and expensive for energy companies to hedge and manage the risks associated with participating in the commodity markets and providing services and products to end-use customers at the lowest reasonable price. Further, even if an energy company's derivatives activities are nowhere near the position limits, their counterparties may nonetheless require a determination as to whether their positions are bona fide hedges so that the counterparty may qualify for the exemption.

Energy companies that execute derivatives through multiple affiliates have also noted concerns with the CFTC's reproposed rules relating to the aggregation of positions or accounts for the purpose of determining compliance with position limits. The reproposed aggregation rule provides broader exemptions to permit disaggregation than the original version of this rule; however, notwithstanding these exemptions, concerns over aggregation still remain. For example, significant operational issues may arise when a parent entity does not have control over the trading decisions of a subsidiary entity or when certain affiliated entities engage in significant hedging activities that require claiming of the hedging exemption.

To date, the comment period for the proposed position limits rule has been reopened and/or extended on three occasions, which is a good sign that the CFTC is carefully considering the concerns raised by market participants. The most recent comment period was opened in December 2014, in light of questions posed at the CFTC's Agricultural Advisory Committee meeting concerning bona fide hedging. The reopened comment period closed on Jan. 22, 2015.

CFTC Chairman Timothy Massad recently announced that his goal is try to finalize the reproposed position limits rule and aggregation rule by the end of 2015

Margin and Capital Requirements

The CFTC and prudential regulators reproposed rules in late 2014 related to margin requirements for uncleared swaps that would require swap dealers and major swap participants (i.e., swap entities) to collect variation margin and, in some cases, initial margin, from energy companies that fall within the definition of "financial end user" as defined under the rules (such definition includes, among other entities, several regulated entities such as commodity pools, insurance companies and private funds). Swap entities would not be required to collect initial or variation margin from energy companies that are not themselves swap entities or that fall outside the type of entities described in the "financial end user" definition.

The good news is that Congress recently acted to provide commercial end users certainty that they will not be subject to margin requirements for their uncleared swaps. On Jan. 12, 2015, after approval by both the House and the Senate, President Obama signed into law HR 26, the Terrorism Risk Insurance Program Reauthorization Act of 2015, which incorporated the language from HR 634/S 888, the Business Risk Mitigation and Price Stabilization Act, which is colloquially referred to as the end-user margin bill.

The amendment provides clarity to Dodd-Frank to ensure that regulators cannot impose margin requirements on end users for swaps that qualify for the end-user clearing exception.

As discussed above, the CFTC and prudential regulators' reproposed margin rules would effectively exempt most nonfinancial end users from having to post initial margin or exchange variation margin. The HR 26 amendment does not conflict with the reproposals, but some changes will need to be made to the final rules since the amendment exempts those swaps eligible for the end-user clearing exception from margin requirements.

The HR 26 amendment requires implementation "through promulgation of an interim final rule, pursuant to which public comment will be sought before a final rule is issued." It is not clear at this time whether the prudential regulators and CFTC will choose to repropose the reproposals to account for this change in the statutory language or if they will take some other action, such as finalizing portions of the rule and issuing other portions as an interim final rule.

Nonetheless, when final rules are promulgated, energy companies will need to review the final rules for affiliates that do not qualify for the end-user clearing exception to determine whether such entities will be subject to variation and/or initial margin requirements.

Although we expect that many energy companies will be exempt from margin requirements, they may not be able to avoid increased costs that result from capital rules on their swap dealer counterparties. While the prudential regulators have already finalized capital rules for swap dealers under their jurisdiction (through the implementation of Basel III), the CFTC has yet to finalize its capital rules for swap dealers and major swap participants. We expect that the CFTC will repropose its capital rules sometime this year.

Revisions to Reporting and Trading Rules

While the CFTC has finalized many of its swap regulations, including those related to swaps reporting and trade execution, 2015 will likely see the agency "fine-tune the rules or make other changes as appropriate," as explained by Chairman Massad in his recent testimony before the U.S. Senate Committee on Agriculture, Nutrition and Forestry.

The swap reporting rules are one area where we are likely to see some proposed revisions in 2015. In May 2014, the CFTC requested public comment on a number of questions aimed at improving the agency's swap reporting rules and the agency has been working closely with international regulators to ensure cross-border harmonization of reporting rules. If not implemented correctly, changes to the swap reporting rules could place increased costs and operational burdens on energy companies that are currently reporting data to swap data repositories.

With respect to the swap trading rules, on Jan. 29, 2015, CFTC Commissioner J. Christopher Giancarlo published a white paper on reforming and reconsidering the CFTC's swap trading rules. While there are currently no clearing or trading mandates for energy commodity swaps, some companies may nonetheless choose to use electronic trading platforms to execute their swaps. Changes to the swap execution facility rules could aim to increase activity on trading platforms, including in energy derivatives, which could provide additional liquidity pools for energy companies.

Further, with respect to futures trading, the CFTC has indicated that it is working on proposed rules that would set the appropriate minimum block trade sizes for similar types of futures contracts (those sizes

are currently set by futures exchanges). Such a rulemaking, if finalized, could mean that fewer energy futures contracts would qualify as block trades, thereby forcing more futures contracts to be executed on the futures exchange's central limit order book, as opposed to those contracts being executed bilaterally and being brought to the futures exchange for clearing. Such a rule could have particular impacts on illiquid markets and energy companies will want to pay careful attention to the CFTC's progress on this issue.

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