



February 22, 2011

Via Online Submission

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

Re: COMMENTS OF THE UTILITY GROUP, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" – **RIN No. 3038-AD06**

Dear Mr. Stawick:

On December 21, 2010, the Commodity Futures Trading Commission ("CFTC" or the "Commission") issued a Notice of Proposed Rulemaking concerning "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Dealer,' and 'Eligible Contract Participant.'"¹ The purpose of the NOPR is to implement key elements of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")² by establishing, through regulations, certain critical definitions necessary to the regulatory scheme enacted therein. These definitions are the starting point to distinguish market participants that will be directly regulated by the Commission on the one hand, and those that will participate in the over-the-counter ("OTC") market to be regulated by the Commission on the other.

The members of the Utility Group³ are large, investor-owned electric companies. This group represents end-users who reflect restructuring in the electric industry, and, although they are not organized identically, all are physical energy companies with generation, transmission, and

¹ Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80174 (Dec. 21, 2010) ("Definitions NOPR" or "NOPR").

² Public Law No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank").

³ The Utility Group is comprised of American Electric Power, Edison International, Exelon Corporation, and Southern Company.

distribution components to their businesses. The members share the business purpose of selling electricity, and they use swaps to hedge physical commodity price volatility risk. They do not "deal" in swaps; rather, they are customers of swap dealers.

The Utility Group members are also members of the Edison Electric Institute (EEI). The Utility Group supports EEI's comments on the NOPR ("EEI Comments"). These comments are intended to complement the comments submitted by EEI. Due to the significance of these definitions, the Utility Group believes it will be beneficial to the Commission to receive and consider comments directly from industry members as well as their trade groups

Because the members of the Utility Group are physical electricity market participants, the definitions of "Swap Dealer" and "Major Swap Participant," inclusive of the definition of "Hedging or Mitigating Commercial Risk," are the elements of the NOPR most relevant to them. The Utility Group observes that, as a general matter, the Commission has produced a thoughtful analysis of the fundamental elements of what makes an entity a "dealer," or which meets Dodd-Frank's statutory construct of a Major Swap Participant. However, the proposed regulation defining "Swap Dealer" is vague and therefore susceptible to various interpretations that create uncertainty, because it relies on an "interpretive approach" for entities to decide whether they are Swap Dealers.⁴ In addition, the amount proposed for the *de minimis* exception threshold to the Swap Dealer definition is much too low. In contrast, the definition of Major Swap Participant is thorough and clear. An entity can apply the proposed regulation to its activities and understand if it is regulated as a Major Swap Participant. The Commission must correctly and clearly define these terms in its regulations. Because entities that fall within these definitions will be pervasively regulated and, therefore, subject to significant obligations to the CFTC and their counterparties, it is imperative that an entity be able to apply the Commission's definitions as expressed in its regulations and know with certainty whether it is a regulated entity.

The Utility Group respectfully requests the Commissions to reconsider the proposed language of the Swap Dealer definition in order to produce a set of regulations for all of the key definitions that will provide clear and comprehensive regulatory text that permits entities to understand their regulatory status. Although the preamble to the NOPR provides helpful clarity in line with what the Utility Group is requesting herein, as significant legal obligations flow from these regulations, there should be as little ambiguity in the regulatory text itself as possible. As stated by the D.C. Circuit "[I]t is the language of the regulatory text, and not the preamble, that controls." *Nat'l Wildlife Fed'n v. E.P.A.*, 286 F.3d 554, 570 (D.C. Cir. 2002), *supplemented sub nom. In re Kagan*, 351 F.3d 1157 (D.C. Cir. 2003). "The preamble of an agency's rule is akin to the preamble or legislative history of a statute." *Id.* at 569.⁵

⁴ See NOPR at 80177.

⁵ The Supreme Court has made clear that "the preamble is not part of the act, and cannot enlarge or confer powers, nor control the words of the act, unless they are doubtful or ambiguous." *Yazoo R.R. Co. v. Thomas*, 132 U.S. 174, 188 (1889). Thus, like a statutory preamble, a regulatory preamble can add context and contribute to "a general understanding" of a regulation, but a preamble is "not an operative part" of a regulation, nor can the language of a preamble "enlarge or confer powers on administrative agencies or officers." *Id.* (quoting *Ass'n of American R.Rs. v. Costle*, 562 F.2d 1310, 1316 (D.C. Cir. 1977) (internal quotations omitted)). Where, as is the case here, the operative parts of a regulation are not

Specifically, the Commission should alter its bifurcated approach to its entity definition regulations for the reasons explained above. Rather than settling on vague text that requires an "interpretive approach," and a comprehensive and clear regulation for the definition of Major Swap Participant, the Commission should adopt comprehensive regulations for both.⁶ As set forth herein, the analytical framework expressed by the Commission in the NOPR provides a solid framework upon which to craft a meaningful and clear regulation for both terms, and the Utility Group thus proposes to modify the Commission's proposals to achieve that clarity.

The Definition of Swap Dealer

In the NOPR, the Commission has provided a statement of the characteristics of a Swap Dealer. According to the Commission:

- "Dealers tend to accommodate demand for swaps and security-based swaps from other parties;
- Dealers are generally available to enter into swaps or security-based swaps to facilitate other parties' interest in entering into those instruments;
- Dealers tend not to request that other parties propose the terms of swaps or security-based swaps; rather, dealers tend to enter into those instruments on their own standard terms or on terms they arrange in response to other parties' interest; and
- Dealers tend to be able to arrange customized terms for swaps or security-based swaps upon request, or to create new types of swaps or security-based swaps at the dealer's own initiative."⁷

The Commission has further clarified that Swap Dealers "serve as the points of connection" to the swaps market for others.⁸ As also concisely stated by the Commission, "persons who enter into swaps as a part of a 'regular business' are those persons whose function is to accommodate demand for swaps from other parties and who enter into swaps in response to interest expressed by other parties."⁹

The Utility Group believes that the Commission has characterized a Swap Dealer correctly in the NOPR preamble. In the Utility Group's experience, a dealer is an entity in the regular business of dealing in swaps, as opposed to in the underlying cash markets. Dealers react to others' requests for quotes and make markets in swaps to profit from a margin on the bid/ask spread. As

unambiguous on their face, it would be in error to view the rule's preamble as controlling, modifying or expanding the meaning of the regulatory text. See *Costle*, 562 F.2d at 1316.

⁶ NOPR at 80177.

⁷ *Id.* at 80176.

⁸ *Id.* at 80177.

⁹ *Id.*

noted by the Commission, dealers are a point of connection to the market for others and do not enter into swaps to speculate or to hedge the commercial risk of a cash business.

Given that the Commission has identified with clarity the nature of swap dealing, there is no need for an interpretive approach – an approach which does not permit market participants to rely upon a clear regulation to determine their status. Because the Commission has effectively proposed to codify the vague language of Dodd-Frank in the Swap Dealer definition, rather than produce a regulation clarifying that language, if the definition is adopted as proposed, many market participants would be left to wonder whether they are Swap Dealers. The Utility Group should not be required to interpret "tendencies."¹⁰ Its members must be confident that they either are or are not regulated; an ambiguous outcome would be harmful to those that Congress did not intend to regulate through Dodd-Frank. Given the work the Commission has already done, however, it is also unnecessary to settle for such an outcome.

In point of fact, it is possible to build on the Commission's stated concepts and understanding of the nature of dealing to provide the requisite certainty in the regulatory text, which the Utility Group has done as follows:

(ppp) Swap Dealer.

- (1) In general. The term "*swap dealer*" means any person who:
 - (i) Holds itself out as a dealer in swaps;
 - (ii) Makes a market in swaps;
 - (iii) Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
 - (iv) Engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.
 - (a) "Dealer" shall mean a person that acts as a market maker in swaps.
 - (b) "Makes a market" or "market maker" means regularly quoting bid and offer prices for, and standing ready to enter into, swaps.
- (2) *Exception.* The term "*swap dealer*" does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of regular business.
 - (i) The term "Regular Business" means a usual business activity of a person whose function is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties
 - (a) The term "accommodates demand" means enter into swaps to satisfy a business need of other parties.
 - (b) The term "interest expressed by other parties" means requests by other

¹⁰ See *id.* ("We request comment on this interpretive approach for identifying whether a person is a swap dealer.").

parties to enter into swaps for the purpose of satisfying their business purposes.

- (ii) The following activities do not constitute a Regular Business for purposes of this provision
- (a) Entering into swaps for the purpose of hedging or mitigating commercial risk, as defined in Section 1.3(ttt);
 - (b) Entering into swaps for the purpose of benefiting from future changes in the price of the underlying commodity;
 - (c) Entering into cleared swaps on a designated contract market or swap execution facility, unless such swaps are entered into by a party who holds itself out as making a market in the corresponding category of swaps.¹¹

(3) *Scope.* A person who is a swap dealer shall be deemed to be a swap dealer with respect to each swap it enters into, regardless of the category of the swap or the person's activities in connection with the swap. However, if a person makes an application to limit its designation as a swap dealer to specified categories of swaps or specified activities of the person in connection with swaps, the Commission shall determine whether the person's designation as a swap dealer shall be so limited. A person may make such application to limit its designation at the same time as, or at a later time subsequent to, the person's initial registration as a swap dealer.

Much of this text is the Commission's own proposed language. The additional language the Utility Group proposes uses the Commission's own language from the NOPR's regulatory preamble to provide enough clarity to enable its members and similarly-situated entities to know with certainty whether they are Swap Dealers.

The above proposed definitions of the terms "Dealer," and "Makes a market" or "Market Maker," are either found in the Commission's glossary of terms on its website, or reflect paraphrasing of those terms.¹² The Utility Group believes that the CFTC's own clear and unbiased definitions from these sources provide needed clarity to these terms as they will be used in the definitions of entities regulated under Dodd-Frank.

The definition of Regular Business comes from the construction articulated by the Commission in the NOPR's preamble. As stated therein, a regular business is: "a person's business activity in which, as its primary function, such person accommodates demand for swaps from other persons

¹¹ Some exchanges and trading platforms (e.g., ICE) allow certain parties that trade for exclusively non-hedging purposes to be designated as "market makers." Unlike other traders, market makers receive tangible benefits (e.g., no trading fees, rebates, etc.) in exchange for performing certain contractually defined responsibilities (e.g., being ready, willing and able to effect transactions, and/or provide bids and offers to other market participants).

¹² *CFTC Glossary, A Guide to the Language of the Futures Industry*, 17 (visited Feb. 20, 2011), <http://www.cftc.gov/ucm/groups/public/@educationcenter/documents/file/cftcglossary.pdf>, ("CTFC Glossary").

by entering into swaps in response to interest or inquires by such other persons."¹³ The further language proposed in the definition clarifies that: (1) "accommodating demand" means filling a market need for swaps; and (2) "Interest expressed by other parties" means responding to a counterparty that requires a swap to meet its business needs. The Utility Group believes it has stayed true to the NOPR's intent and offered a useful and clear definition.

Of course, in defining a term, explaining what the definition does *not* cover can be helpful. In this case, some of the proposed components of the regulation make clear that: (1) hedging, (2) speculating, and (3) entering into exchange-traded cleared swaps are not dealing. None of these transactions are accommodating demand for swaps from other persons by entering into swaps in response to interest or inquires by such other persons. Hedging is managing one's own commercial risk. Speculating is attempting to profit from one's own market view. Exchange-traded cleared swaps are blind transactions without a bilateral counterparty (structured in a manner almost identical to futures transactions).

Therefore, based on the foregoing, the Utility Group believes that the Commission must provide market participants with clear regulatory text from which they can determine their status under Dodd-Frank. The Utility Group has proposed such regulatory text, which also hews closely to the Commission's stated understanding of dealing activity as conveyed in the NOPR. The Commission should move away from the interpretative approach proposed in the NOPR and, instead, adopt the regulation proposed above.

Although Electricity Companies Use Swaps, They Are Not Swap Dealers

In the NOPR, the Commission specifically requested comments concerning the characteristics of the electricity industry and how they relate to the issues raised by the NOPR.¹⁴ The Utility Group appreciates the Commission's interest in this topic and believes that such comments will help the Commission better understand the use of swaps by electricity market participants. Set forth below is a brief history of the industry's evolution and the role of swaps in the electricity market. Information regarding Utility Group members and their use of swaps is also provided. The Utility Group believes that the industry context described below will assist the Commission's understanding of the electricity market and of the clarity that the regulatory text proposed above will provide to that market.

Although the electricity business has undergone significant structural change, it has been and continues to be a physical business subject to significant regulatory oversight. Initially, electric utilities were vertically integrated companies (including generation, transmission, and distribution) serving customers at retail within a franchised service area. They were regulated by state public service commissions and had little or no wholesale transactions with other utilities. Over time, as service areas expanded, electric utilities began to interact more frequently with one another and wholesale sales increased.¹⁵ As these sales often spanned more than one state,

¹³ See NOPR at 80177.

¹⁴ *Id.* at 80183.

¹⁵ *Public Utilities Comm'n v. Attleboro Steam Co.*, 273 U.S. 83 (1927).

federal regulation of wholesale electricity sales as well as interstate transmission by the Federal Power Commission¹⁶ began in 1935¹⁷ with the enactment of Part 2 of the Federal Power Act.¹⁸

The regulatory structure begun in 1935 with state regulation of vertically integrated retail sales and federal regulation of wholesale sales, and stand-alone transmission continued largely unchanged for about 45 years. However, beginning in the late 1970s, public policy began to shift from an exclusively regulatory model to one that included more competition. As a result, in the Public Utility Regulatory Policies Act of 1978 ("PURPA"),¹⁹ Congress created a new type of electricity market participant, the Qualifying Facility (QF). A QF is an electricity generator with certain attributes which, *inter alia*, has the right to require an electric utility to purchase its output at wholesale. Throughout the 1980s, FERC implemented competition-oriented policies in gas and electricity markets furthering the creation of competitive players in energy markets.

In 1992, Congress enacted the Energy Policy Act.²⁰ That statute created new competitive generating entities, known as Exempt Wholesale Generators ("EWG"),²¹ and required for the first time that electric utilities offer transmission service to others under certain conditions. In keeping with the federal pro-competitive policy, in 1996 FERC issued Order No. 888, requiring all electric utilities to file open-access transmission tariffs ("OATT").²² FERC also created a type of utility called a "power marketer" (typically electricity merchants that need not own any physical facilities). To facilitate these wholesale and transmission markets, FERC established a new type of transmission and energy market administrator called an Independent System Operator ("ISO") or Regional Transmission Organization ("RTO"). Beginning in the late 1990s, in certain regions of the country, states took actions to restructure their local utilities. To varying degrees, they instituted open access to electric distribution, required their regulated utilities to divest generation to the competitive market, and permitted third party sellers of retail electricity.

All of the forgoing activity triggered the growth of an electricity trading market. That market began as a wholly physical market. As the market grew, it developed standardized trading

¹⁶ The Federal Power Commission is the predecessor to the Federal Energy Regulatory Commission ("FERC").

¹⁷ Due to corporate abuses occurring at the holding company level, the Public Utility Holding Company Act ("PUCHA") was also enacted which subjected holding companies to significant regulation by the Securities and Exchange Commission. *See* 15 U.S.C. §§ 79(o), 79(t).

¹⁸ 16 U.S.C. 791-828c (Part 2 is Chapter 687, 49 Stat. 803).

¹⁹ *See* 17 USC § 2601 et seq.

²⁰ Pub. L. No. 102-486 (codified in various sections of the U.S. Code).

²¹ EWGs are exempt from PUHCA.

²² Order No. 888, FERC Stats. & Regs. ¶ 31,036, 61 Fed. Reg. 21,540 (1996), *clarified* 76 FERC ¶ 61,009 and 76 FERC ¶ 61,347 (1996), *on reh'g*, Order No. 888-A, FERC Stats. & Regs. ¶ 31,048, 62 Fed. Reg. 12,274, *clarified*, 79 FERC ¶ 61,182 (1997), *on reh'g*, Order No. 888-B, 81 FERC ¶ 61,248, 62 Fed. Reg. 64,688 (1997), *on reh'g*, Order No. 888-C, 82 FERC ¶ 61,046 (1998), *aff'd sub nom. Transmission Access Policy Study Group v. FERC*, 225 F.3d 667 (D.C. Cir. 2000), *aff'd sub nom. New York v. FERC*, 535 U.S. 1 (2002).

documentation.²³ Natural gas trading markets also developed such standardized documentation.²⁴ Over time, futures and swaps came into use among market participants.

In 2005, Congress enacted bankruptcy law amendments that removed ambiguity concerning the legitimacy of close-out netting of physical and derivative products.²⁵ With that clarification, a process was initiated involving the International Securities and Derivatives Association ("ISDA") to put all energy trades – i.e. both physical and financial (swaps) - under one standardized agreement. Accordingly, the ISDA Agreement was expanded to include electricity and gas transaction annexes. Also during this period, several competitive energy companies experienced serious financial issues causing a need to put in place documentation with strong credit terms and to ensure that netting could occur to the extent possible to limit credit exposures. As a result, more and more financial entities saw and pursued the opportunity to engage in over-the-counter swap dealing in energy products.

As a result of the foregoing, swaps began to have a more prominent role in electricity markets. In today's markets, swaps are an efficient means to hedge physical electricity exposure. In these markets, swaps can be designed to closely track the underlying physical market. Because swaps can be netted against physical gas and electricity transactions, they can be used to reduce exposures. For longer-term transactions, swaps have more liquidity than physical transactions, largely because bank dealer/market maker entities prefer them.²⁶

Accordingly, electric market participants enter into swaps because they are economically efficient hedges, have liquidity (and thus best pricing), and closely track the physical market. As these entities are in the business of buying and selling electricity to ultimately serve retail electricity customers, they enter into physical transactions or their swap equivalents to fix prices, while also continuing to deliver a physical product. They are electricity producers, buyers, and sellers. They do not deal in swaps, but rather they use swaps as a tool to manage risk inherent in their physical energy businesses.

The increase in the role of swaps in this market is a relatively recent development. The impact of Dodd-Frank on the continued utility of swaps is unclear at this time. For example, if swaps are required to be cleared, they cannot be netted against physical exposures. If clearing is not required, but swap trading requires margin not currently contained in the "collective exposure ISDA," the benefits of netting will be similarly impacted. If the regulations under Dodd-Frank affect the price of swaps such that they exceed equivalent physical transactions, there will be movement away from swap trading in the energy-related markets. In addition, if the use of

²³ See EEI Master Power Purchase and Sale Agreement.

²⁴ See North American Energy Standards Board Base Contract for the Sale and Purchase of Natural Gas.

²⁵ See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub.L. 109-8, 119 Stat. 23, enacted April 20, 2005),

²⁶ Some of the bank dealer/market makers have physical capabilities while others do not.

swaps by electricity market participants renders them swap dealers, they will likely limit swap transactions.

Utility Group Members

The Utility Group members, while not identically structured, are in the physical electricity business. Some of the companies are vertically integrated (AEP, EIX, and Southern Company), while others have moved generation to an affiliate (Exelon). Some of the companies have a significant merchant generation affiliate in a region remote from their utility operations (EIX) or in addition to utility generation (SC). Some of the companies have divested generation as a result of public policy determinations by regulators (EIX).

As set forth below, among the many things Utility Group members have in common is that they use swaps as a risk management tool. They do not engage in a regular business of accommodating demand for swaps from other persons in response to interest or inquiries by such other persons. They are not swap dealers.

American Electric Power (AEP)

Headquartered in Columbus, Ohio, AEP ranks among the nation's largest generators of electricity, owning nearly 38,000 megawatts of generating capacity in the United States. AEP also owns the nation's largest electricity transmission system, a nearly 39,000-mile network that includes more 765 kilovolt extra-high voltage transmission lines than all other transmission systems in the United States combined. AEP's transmission system directly or indirectly serves about 10 percent of the electricity demand in the Eastern Interconnection, the interconnected transmission system that covers 38 Eastern and Central States and Eastern Canada, and approximately 11 percent of the electricity demand in the Electric Reliability Council of Texas (ERCOT) system, the transmission system that covers much of Texas. Together, AEP's eleven utility companies serve more than 5 million American customers in 11 states.²⁷ Their service territories include over 186,000 miles of distribution lines and cover 197,500 square miles in Arkansas, Indiana, Kentucky, Louisiana, Michigan, Ohio, Oklahoma, Tennessee, Texas, Virginia, and West Virginia. The services provided by AEP's utility companies to retail ratepayers are extensively regulated by the public utility commissions of these states.

Through agreements on file with FERC, AEP's generation-owning utilities operate as a "pool" in which the combined generating assets of the companies are used to serve the total load of their customers in the Eastern and Western parts of AEP's system. To the extent AEP generates power that exceeds the requirements of its load, that excess is generally sold to third parties (such as a FERC-designated RTO) at wholesale. Throughout its history, AEP has also supplied the full or partial power needs of a number of municipalities, rural electric cooperatives, and smaller load serving entities near its service territory. These sales are sourced both from AEP's generation and from market purchases.

²⁷ AEP's utility companies include Columbus Southern Power Company, Ohio Power Company, AEP Texas Central Company, AEP Texas North Company, Appalachian Power Company, Indiana Michigan Power Company, Kentucky Power Company, Public Service Company of Oklahoma, Southwestern Electric Power Company, Kingsport Power Company and Wheeling Power Company.

As the RTO markets have evolved, this business has evolved as well to include the sale of power, capacity, ancillary services (transmission-related services required to be provided by load serving entities), and functionally equivalent financial products to these customers. AEP also engages in power and natural gas trading, including both physical and financial products, for various purposes including price discovery, to hedge its net generation and supply obligations, and also for purposes of benefiting from future changes in the price of the underlying commodity. The margins from its wholesale business are shared with retail ratepayers in many of the states in which AEP's "pool" operates and therefore reduce the prices that they pay the company for electricity.

AEP also includes AEP Energy Partners, Inc. (AEPEP). AEPEP operates primarily in the ERCOT region of Texas. AEPEP makes sales of power primarily to municipal electric systems and rural electric cooperatives. The company also manages power generation assets and engages in trading of electricity and natural gas in ERCOT that is similar in purpose to that of the AEP utility companies.

AEP best corresponds to Example No 6 (b) set forth in the EEI Comments.

Edison International (EIX)

EIX, through its subsidiaries, is a generator and distributor of electric power and an investor in infrastructure and energy assets. EIX is the parent company of Southern California Edison ("SCE"), a regulated electric utility, and Edison Mission Group ("EMG"), a competitive power generation business.

SCE is an electric utility that provides electricity service to nearly 14 million people in Central, Coastal and Southern California, and engages in bona fide hedges solely for the mitigation of commercial risks relating to such service in order to provide a reliable and stable-priced electricity supply for its customers. SCE's business purpose is the sale of electricity services to residential, commercial, and industrial customers within its service territory. SCE owns and operates electric generation, transmission, and distribution facilities needed to supply power to its customers, and it is compensated for such service at rates regulated by the California Public Utilities Commission ("CPUC"). Such rate regulation limits the revenues SCE can collect for its services based on CPUC-established cost recovery mechanisms which, in general, are designed to enable SCE to recover prudently-incurred costs of service and to earn an authorized rate of return on capital employed to construct, operate, and maintain assets required to provide electricity service.²⁸

SCE is authorized by the CPUC to provide electricity service in a franchised service territory located in Central, Coastal and Southern California. SCE serves electricity to its customers from its utility-owned generation resources and from electricity purchased from independent power producers and competitive wholesale electricity markets. SCE's power procurement plans are

²⁸ Additionally, SCE's wholesale operations (including sales of electricity into the wholesale markets) are subject to regulation by FERC.

subject to CPUC review and approval under California Assembly Bill 57 (“AB 57”). AB 57, among other things, calls for SCE to assemble a portfolio of power supply sources (whether generated by SCE-owned plants or purchased from third parties) sufficient to ensure that reliable, least-cost power is delivered to all customers within its service territory.²⁹ Part of the CPUC’s mandate regulates the types of derivative transactions in which SCE can engage. AB 57 was passed after the California electricity crisis of 2000-2001 in an effort to protect California’s ratepayers from further financial harm associated with the provision of electric service.

EMG is a holding company which acts through a number of subsidiaries to manage the competitive power generation business of EIX subsidiaries. One of its principal subsidiaries, Edison Mission Energy (“EME”), is an independent power producer engaged in the business of owning, leasing, operating, and selling energy and capacity from electric power generation facilities. Because EME produces power in a wholesale market characterized by volatility in both its inputs (primarily fuel) and its output (power), the company conducts price risk management and energy trading activities through its subsidiary, Edison Mission Marketing and Trading (“EMMT”).

EMMT executes and administers financial derivatives for hedging activities on behalf of EME subsidiaries, including financial derivatives to hedge the output risk from EME’s coal-fired generation plants. EMMT also utilizes heating oil financial derivatives to hedge against the rail transportation costs of coal because EME’s rail contracts include cost escalation provisions, with a fuel cost adjustment factor correlated to heating oil prices. In addition, EMMT utilizes financial congestion contracts to hedge against transmission congestion in PJM Interconnection, LLC (“PJM”) (a regional transmission organization), where EME’s coal-fired generation output is sold. On occasion, EMMT also regularly enters into financial derivatives on its own account

²⁹ AB 57, Cal. Pub. Util. Code § 454.5, enacted in 2002, mandates that Investor Owned Utilities (“IOUs”) prepare Long Term Procurement Plans (“LTTPs”) for review and approval by the CPUC and ensures that all costs associated with transactions executed by an IOU are in accordance with its CPUC-approved LTTP will be recoverable through rates. Procurement plans are prepared at the direction of the CPUC generally every other year. The CPUC, to date, has granted SCE approval to engage in certain transaction types, including physical and financially-settled spot and forward market purchases and sales (including options) of electricity, transmission, natural gas, pipeline capacity, storage, and emissions.

The LTTP provides standards for:

- Procurement products for electric and gas procurement;
- Transactional processes for electric and gas procurement (including “Requests for Offer,” transactions on exchanges, transactions through brokers and bilateral transactions);
- Evaluation and selection of energy resources through a “Requests for Offer” process;
- Contract duration;
- Limits on the volume of electric energy and natural gas that SCE can procure;
- Risk management policies and strategies; and
- Fuel supply procurement strategy.

for direct gain based on EMMT's view of market trends. EMMT's business does not (a) engage in exotic derivatives; (b) provide asset management services to third parties; or (c) solicit originating products.

EIX best corresponds to Example No. 2 (EME) and Example No. 6 (a) (SCE) in the EEI Comments.

Exelon Corporation (Exelon)

Exelon is a holding company that owns and operates more than 30,000 MW of generating units, owns or maintains electric transmission facilities that deliver bulk power to local electric distribution systems, and owns and operates two local electric distribution systems. Exelon also owns and operates hydro-electric facilities located in Northeastern Maryland and a pumped storage facility in nearby Southeastern Pennsylvania, both on the Susquehanna River. Exelon conducts these businesses through three primary companies that it holds directly or indirectly.

PECO Energy Company (PECO): PECO owns transmission lines that are part of the electric grid operated by the PJM Interconnection L.L.C. (PJM) RTO. In addition, PECO also delivers electricity through its electric distribution system, and sells electricity to retail customers that have not switched to a retail marketer³⁰ in its service territory in Southeastern Pennsylvania, including the City of Philadelphia (approximately 1.6 million retail customers). PECO also provides natural gas distribution and supply to about 500,000 retail customers in suburban Philadelphia.

Commonwealth Edison Company (ComEd): ComEd's business is similar to that of PECO, except it does not provide any natural gas service. It owns transmission facilities in the PJM RTO. Its retail service territory spans from Chicago west to Illinois's border with Iowa and contains approximately 3.8 million customers. Illinois also has enacted retail completion.

Exelon Generation Company, LLC (ExGen) has: (1) the largest fleet of nuclear power plants in the United States, (2) fossil-fired power plants in Illinois, Pennsylvania, Oklahoma, and Texas; and (3) wind power facilities in Idaho, Michigan, Minnesota, Texas, West Virginia, Pennsylvania, Missouri, and Oregon.

ExGen's Power Team division's primary responsibilities are to offer these generation facilities daily into the markets in which they are located, and to hedge the price risk associated with the generation portfolio they represent by selling physical power to: (1) vertically integrated, traditional utilities; (2) utilities in markets with retail competition that must serve customers who do not switch to competitive retail suppliers; (3) municipalities and electric cooperatives; and (4) its wholly-owned competitive retail supplier Exelon Energy Company, which provides competitive retail supply currently to customers in Illinois and Pennsylvania.³¹ In addition, the Power Team has a substantial book of exchange-traded and cleared swaps, and over-the-counter

³⁰ Pennsylvania is a state that has retail competition.

³¹ Exelon Energy Company also supplies natural gas to retail customers in Ohio, Michigan, and Illinois.

swaps, almost all of which are for the purpose of hedging the price risk associated with the generation not committed to physical wholesale supply. The Power Team enters into a small notional amount of transactions representing a price discovery function (entering into speculative swaps, or otherwise obtaining reliable information about market prices). This activity represents approximately one percent of ExGen's transactions (both physical sales and OTC swaps). ExGen does not make markets in swaps.

Exelon best corresponds to Example No. 2 in the EEI Comments.

Southern Company

Based in Atlanta, Southern Company is one of the largest generators of electricity in the nation, serving both regulated and competitive markets across the Southeastern United States. It participates in all phases of the electric utility business with more than 42,000 megawatts of electric generating capacity and a grid of transmission and distribution lines that would more than circle the earth. Southern Company and its subsidiaries have been serving the Southeast for more than 100 years.

Southern Company provides retail electric service as regulated by the public service commissions in the states served and by federal energy agencies. Public service commissions determine fair electric rates, oversee what project costs can be recovered (for environmental controls or plant construction), and define the profit margin utilities can make in retail markets. Southern Company's four electric utilities - Alabama Power, Georgia Power, Gulf Power, and Mississippi Power - serve 4.4 million retail customers (through 2008).

Southern Company also sells power in the wholesale market and transmits wholesale power for other providers. Southern Power, the higher-growth competitive wholesale generation business comprises more than 7,700 megawatts. In all, Southern Company generation serves about 75 investor-owned utilities, electric cooperatives, and municipalities in Alabama, Florida, Georgia, Mississippi, and the Carolinas.

Southern Company has responsibility for approximately \$6.2 billion in transmission assets including more than 27,000 miles of transmission lines, 3,700 substations, and 300,000 acres of right of way. The transmission system meets North American Electric Reliability Council standards and provides a safe and reliable grid. Southern Company plans, designs, builds, operates, and maintains its system to meet growing demand.

Southern Company best corresponds to Example No 6 (b) set forth in the EEI Comments.

De Minimis Exception

The Utility Group believes the *de minimis* exception is an important element of the overall regulatory definition of a Swap Dealer. Congress recognized that there are "dealing" activities in which non-dealers engage. To the degree these activities are insignificant in the context of the swaps market, they should not draw those entities into a category that would subject them to regulation as Swap Dealers.

As proposed, the *de minimis* exception's threshold is much too low. The provisions that are based on the amount of swaps or counterparties over the prior twelve month period, beyond representing inappropriately low numbers, are not a meaningful measure of dealing activity. The amount of counterparties or swaps undertaken in a twelve month period does not provide any useful information about the significance of the associated dealing. If the gross notional dollars are insignificant, the dealing is *de minimis*. As such, the Commission should eliminate these criteria from its definition of *de minimis*.

The Commission has correctly proposed a total market *de minimis* threshold, as most dealers make markets in swaps with many different underlying commodities and financial obligations. Further, the amount of gross notional value that exceeds an insignificant level is necessarily a matter of judgment. However, while a matter of judgment, the *de minimis* threshold should be set with reference to the overall market. A \$100 million gross notional ceiling in a market as large as the U.S. swaps market³² is clearly too low.

Accordingly, in keeping with the Commission's total market structure but keying the trigger to the overall market, the Utility Group recommends a figure of 0.001% (one-thousandth of one percent) of the U.S. swap market for the threshold of the *de minimis* exception.³³ One-thousandth of one percent is *de minimis* by any measure. By using a percentage of the gross notional average annual value of the swap market for the previous calendar year, the Commission's regulations will not become frozen in time but will continue to appropriately measure a *de minimis* value.

Consistent with the above discussion, the Utility Group recommends the following regulatory text:

(4) *De minimis exception.* A person shall not be deemed to be a swap dealer as a result of ~~swap dealing~~ Regular Business activity involving counterparties, that meets ~~each of~~ the following conditions:

(i) The swap positions connected with those activities into which the person enters over the course of the immediately preceding 12 months have an aggregate gross notional amount of no more than ~~\$100 million, and have an one-thousandth of one percent (.001%) of the~~ aggregate gross notional amount of ~~no more than \$25 million with the overall swaps market.~~ With regard to swaps in which the counterparty is a "special entity" (as that term is defined in Section 4s(h)(2)(C) of the Commodity Exchange Act), the amount shall be one-ten thousandth of one percent (.0001%) of the overall swaps market. For purposes of this paragraph, if the stated notional amount of a swap is leveraged or enhanced by the structure of the swap, the calculation shall be based on the effective notional amount of the swap rather than on the stated notional amount.

³² See Testimony of Chairman Gary Gensler Before the House Committee on Agriculture (February 10, 2011) (referring to gross notional value of OTC swap market alone as being approximately \$300 trillion).

³³ In the event the Commission does not continue to base a *de minimis* level on the entire U.S. swap market, it should provide its revised concept for comment.

~~(ii) — The person has not entered into swaps in connection with those activities with more than 15 counterparties, other than swap dealers, over the course of the immediately preceding 12 months. In determining the number of counterparties, all counterparties that are members of a single group of persons under common control shall be considered to be a single counterparty.~~

~~(iii) — The person has not entered into more than 20 swaps in connection with those activities over the course of the immediately preceding 12 months. For purposes of this paragraph, each transaction entered into under a master agreement for swaps shall constitute a distinct swap, but entering into an amendment of an existing swap in which the counterparty to such swap remains the same and the item underlying such swap remains substantially the same shall not constitute entering into a swap.~~

Major Swap Participant

The Utility Group believes that the Commission has properly defined the term Major Swap Participant in the proposed regulations. In defining Major Swap Participant, the NOPR provides the clarity missing from the Swap Dealer definition and does not require an overly subjective, interpretive approach that would yield uncertainty. There are five key aspects that make this regulation work:

- A Major Swap Participant is not a Swap Dealer. It is not in the Regular Business of accommodating demand for swaps from other persons by entering into swaps in response to interest or inquires by such other persons.
- A Major Swap Participant is not a commercial hedger. As the calculation of "Substantial Position" is net of swaps used to hedge or mitigate commercial risk, hedging activities will not trigger Major Swap Participant status.
- A Major Swap Participant is a speculator. If an entity's swaps are not entered into for dealing or hedging, they are entered into to speculate (for the purpose of benefiting from future market price changes affecting the value of the swap).
- The definition of "hedging or mitigating commercial risk" properly captures hedging activities.
- The calculation of "substantial position" properly only captures entities whose failure could cause a systemic impact on the financial markets of the United States.

Therefore, the determination underlying Major Swap Participant status is whether the entity speculates in swaps at a level sufficient to impact the financial markets of the United States if it defaults.

In making its determination, the Commission must define "hedging or mitigating commercial risk" to exclude associated swaps from the calculation of "substantial position." The regulatory text proposed by the Commission properly captures the concept of hedging commercial risk. It is designed to cover risk mitigation in a commercial enterprise that stems from the potential

value changes associated with: producing, manufacturing, or merchandising; liabilities incurred in the ordinary course of business; services provided or purchased in the ordinary course of business; assets, services, inputs, products, or commodities owned, produced, manufactured, possessed, merchandised, leased, or sold in the ordinary course of business; currency exchange or interest rate changes impacting a person's business; or any position that qualifies for a bona fide hedge exemption from position limits or for hedge accounting under FASB Topic 815.³⁴ The broad and inclusive scope of activities identified in the text tracks the Utility Group's use of swaps to mitigate or hedge commercial risk.³⁵

Similarly, the NOPR defines "substantial position" at an appropriate level with enough specificity for an entity to understand whether it is covered.³⁶ The definition is effectively "\$2 billion in daily average current uncollateralized exposure plus aggregate potential outward exposure in the applicable major swap category."³⁷

Disregarding Affiliate Transactions in Swap Dealer and Major Swap Participant Determinations

Given the varying corporate structures of the Utility Group members and others in the electricity industry, it is appropriate that internal intra-corporate transactions be excluded from determining whether an entity is a Swap Dealer or Major Swap Participant. These transactions generally take the form of an affiliate that is active in the market acting on behalf of an operating affiliate to hedge its risk. This type of internal transaction exists to promote operating and credit netting efficiency within a corporate structure. These internal non-market transactions should not be considered in any determination of whether an entity is a Swap Dealer or a Major Swap Participant.

Dodd-Frank itself supports the concept that inter-affiliate transactions should be disregarded. Section 723 of Dodd-Frank provides that an affiliate of an end-user that is entitled to claim the exception from clearing provided by § 2(h)(7)(A) of the CEA as amended by § 723 may claim that same exception based on its affiliate's end-user status.³⁸ A finance affiliate of an entity entitled to the end-user exception from clearing may claim that same exception if it is acting on behalf of its end-user affiliate to hedge or mitigate commercial risk (provided that the affiliate is not itself a Swap Dealer or Major Swap Participant or other financial entity).³⁹ Because inter-affiliate transactions are expressly disregarded when a person is opting out of clearing (a critical

³⁴ See NOPR at 80215.

³⁵ There should be one interpretation of the definition of hedging or mitigating commercial risk regardless of whether it is used to define Major Swap Participant or to apply the end-user exception from clearing. In each case, the terms are used in the same manner. Different definitions would lead to confusion and serve no purpose.

³⁶ Since the NOPR uses a set dollar value, the Utility Group suggests an annual escalator tracking any inflation in the value of the US Dollar.

³⁷ NOPR at 80193.

³⁸ Dodd-Frank § 723 (as codified at § 2(h)(7)(D)).

³⁹ *Id.*

aspect of Dodd-Frank), the same transactions should not be considered when the Commission is defining activities that determine whether a person is a Swap Dealer or Major Swap Participant.

Specifically, affiliate transactions should be disregarded: (1) in the determination of whether a swap is a part of a Regular Business; (2) in the calculation of the *de minimis* exception; and (3) in the determination of a Substantial Position. The Utility Group proposes the following regulatory text to ensure that affiliate transactions will not count in these determinations:

(1) Swaps entered into among Affiliates shall not be considered to be a part of a Regular Business for purposes of §§ 1.3(ppp) and 1.3(ppp)(4).

(2) Swaps entered into among Affiliates shall not be included in the calculation of a Substantial Position for the purposes of § 1.3(sss).

Conclusion

For the foregoing reasons, the Utility Group respectfully requests that the Commission provide market participants with additional clarity and certainty in its final rules allowing them to clearly understand their regulatory status. The Commission's formulation of the terms Swap Dealer and Major Swap Participant is conceptually valid. However, its proposed regulations for the definition of Swap Dealer are vague. The Utility Group respectfully requests that the Commission adopt the modifications and additions to the NOPRs regulatory language proposed herein. The result will be regulatory certainty, with only "real" swap dealers covered by the definition.

Mr. David A. Stawick
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