

Via Electronic Submission

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

Re: Comments on the Hedging Exclusion for Physical Positions Interim Final Rule (RIN 3235-AK65)

Dear Mr. Stawick:

The Electric Power Supply Association (“EPSA”) respectfully submits these comments in response to the Commodity Futures Trading Commission’s (the “Commission”) Hedging Exclusion for Physical Positions Interim Final Rule (the “Interim Final Rule”).¹ On April 18, 2012, the Commission issued its Final Rule and Interim Final Rule on the Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant,” and “Eligible Contract Participant.” (“Entity Definitions Final Rule”). The Final Rule defines the entities that are required to comply with the rules for participating in the swaps market under the Commodity Exchange Act (“CEA”) as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) and the Commission’s rules that are applicable to all “swaps.”² The Interim Final Rule provides an exclusion from the categories of transactions determining status as a “Swap Dealer” those transactions that are entered into for the purpose of hedging physical positions. The Commission requested comments on the Interim Final Rule.³

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.

EPSA members are physical commodity market participants that rely on commodity swaps, futures, and options primarily to hedge and mitigate commercial risk. They are not financial entities. As users of swaps to hedge commercial risk, EPSA members have a direct and

¹ *Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant, and “Eligible Contract Participant”*, 77 Fed. Reg. 30596 (May 23, 2012).

² Pub. L. No. 111-203 (2010).

³ 77 Fed. Reg. at 30613.

significant interest in how the Commission regulates transactions in nonfinancial commodities, and in particular, swaps on nonfinancial commodities.

I. Summary of EPSA's Comments on the Interim Final Rule

EPSA generally supports the Commission's Interim Final Rule providing an exclusion for hedging physical positions, which excludes from the pool of transactions used to determine a market participants' status as a "Swap Dealer" those transactions used to hedge physical positions. The hedging exclusion for physical positions would allow entities to use swaps to hedge physical positions without having to include such physical hedging transactions in their analysis of whether they are a "Swap Dealer."

The Commission issued the Interim Final Rule providing the definition of hedging for physical positions in response to numerous comments filed requesting that swaps used to hedge or mitigate commercial risk should not be considered in determining whether an entity is a "Swap Dealer." EPSA appreciates and supports the Commission's efforts to accommodate these concerns and provides the following limited comments on some aspects of the Interim Final Rule:

- EPSA supports an exclusion of hedging swaps from the "Swap Dealer" analysis
- EPSA argues the exclusion for hedging physical positions should permit entities to hedge both the physical and financial risks associated with physical positions
- EPSA argues that multiple definitions of "hedging" will cause confusion and increase costs

II. Overview of the Hedging Exclusion for Physical Positions Interim Final Rule

In the Final Rule further defining the term "Swap Dealer," the Commission stated "in general, entering into a swap for the purpose of hedging is inconsistent with swap dealing."⁴ Therefore, the Commission issued an Interim Final Rule that provides an exclusion from the transactions used to determine a market participant's status as a "Swap Dealer" for those transactions that intend to hedge for physical positions under new §1.3 (ggg)(6)(iii). The elements of a swap transaction that will be excluded from the determination of an entity's status as a "Swap Dealer" are based on the principle of bona fide hedging that the Commission has previously used to determine when a financial instrument is used for hedging purposes.⁵ To qualify for the exclusion, the swap transaction must:

⁴ 77 FR 30611 (May 23, 2012).

⁵ 77 FR 30612 (May 23, 2012).

1) Be entered into for the purpose of offsetting or mitigating a person's price risks that arise from the potential change in the value of one or several:

assets the person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, processing, or merchandising;

liabilities that the person owns or anticipates incurring; or

services that the person provides, purchases, or anticipates providing or purchasing;

2) Represent a substitute for transactions made or to be made or positions taken or to be taken by the person at a later time in a physical marketing channel;

3) Be economically appropriate to the reduction of the person's risk in the conduct and management of a commercial enterprise;

4) Be entered into on accordance with sound commercial practices; and

5) Not be entered into in connection with activity structured to evade designation as a swap dealer

In the preamble to the Interim Final Rule, the Commission explained that the exclusion from the definition of swap for purposes of determining status as a "Swap Dealer" does not depend on the effect or the consequence of the swap, but rather on the intention of the swap at the time it was entered into. Therefore, if the purpose for entering into a swap transaction is to hedge a physical position (as defined in the regulations), then that transaction will not be considered a swap for purposes of determining a market participant's status as a "Swap Dealer."⁶

The Interim Final Rule expressly excludes swaps hedging price risks arising from the potential change in value of existing or anticipated assets, liabilities, or services, if the hedger has an exposure to a physical price risk. Similar to the bona fide hedging rule, the exclusion utilizes the word "several" to reflect that there is no requirement that swaps hedge risk on a one-to-one transactional basis in order to be excluded from the definition of swap (for purposes of determining one's status as a "Swap Dealer"), but rather persons may hedge on a portfolio basis.⁷

⁶ 77 FR 30613 (May 23, 2012).

⁷ 77 FR 30612 (May 23, 2012).

III. Comments

A. The Commission Should Exclude Swaps Used for Hedging Purposes from the Swap Dealer Analysis

In the Interim Final Rule, the Commission provides that transactions entered into for the purpose of hedging or mitigating physical positions are excluded from the definition of “swap” for purposes of determining a person’s status as a “Swap Dealer.” Following the explanation, the Commission asks several questions about the Interim Final Rule and seeks comments on the overall approach to excluding swaps entered into for the purpose of hedging or mitigating physical positions.

Initially, the Commission asks if any exclusion of hedging swaps from the “Swap Dealer” analysis is appropriate. EPSA agrees that such exclusion is appropriate. As the Commission states in the preamble to the Final Rule “entering into a swap for the purpose of hedging is inconsistent with swap dealing.”⁸ Additionally, as CFTC Chairman Gensler has stated before the U.S. House of Representatives, the futures and swaps markets are critical for producers and other non-financial end-users in the “real economy” where such non-financial end-users “can lock in a price or rate and manage their risk.”⁹ EPSA’s members are non-financial producers of electric energy for sale in the wholesale market, a critical step in ensuring consumers have readily available, reliable, and inexpensive power. EPSA members frequently rely on futures, forwards, and similar transactions to hedge and mitigate the unique risk of electricity markets. Use of these hedging transactions should not place EPSA members within the camp of “Swap Dealers” as a result of the sound business practices of mitigating risk associated with physical positions. By entering into these hedging transactions, EPSA members are seeking to ensure the price of electricity at wholesale, the service EPSA members are in the business of producing and providing, stays uniformly low and relatively predictable. To classify such entities as “Swap Dealers” based on these hedging transactions, thus forcing them to comply with much more stringent capital, margin, reporting and recordkeeping requirements, would not only violate the intention of the statute, it would also lead to higher costs and more volatile pricing for electric energy consumers. Therefore, a hedging exclusion from the definition of “Swap Dealer” is necessary and appropriate.

B. The Hedging Exclusion Should Permit Parties to Hedge Both Physical and Financial Risks Associated with Physical Positions

The third question the Commission asks in the Interim Final Rule is if the hedging exclusion should be limited to swaps hedging risks related to physical positions or extended to

⁸ 77 Fed. Reg. 30611 (May 23, 2012).

⁹ Chairman Gensler Testimony before U.S. House Committee on Agriculture (February 29, 2012).

encompass swaps hedging financial risk or other types of risks. EPSA argues that the hedging exclusion should permit hedging of both physical and financial risks related to physical positions.

In addition to entering into physical contracts to hedge, EPSA members may also enter into financial contracts to hedge physical positions held. For example, if a market participant has exposure to interest rate fluctuations as a result of financing natural gas inventory held in storage over the gas storage cycle, that market participant would enter into an interest rate swap to hedge their exposure over the storage cycle. The only reason that market participant would enter into that interest rate swap is related to its physical natural gas activities. However, under the definition of hedging in the Interim Final Rule, it is unclear if such a swap, which is entered into solely for the purpose of hedging, would be considered excluded from the definition of swap or if such transaction would be factored into the market participant's status as a "Swap Dealer."

Another example of a financial contract EPSA members may enter into involves a market participant that has exposure to currency rate fluctuations as a result of buying or selling natural gas in Canada. To hedge this exposure, the market participant enters into a foreign exchange swap. The market participant's only reason for entering into the foreign exchange swap is to hedge the risk related to its physical natural gas activities.

Under the second prong of the hedge exemption in the Interim Final Rule, the excluded swap must represent a substitute for transactions made or positions take by the person making the swap at a later time in the physical marketing channel. In the examples provided above, the swaps are not made in the natural gas markets, but they are made with the purpose of hedging risk of the physical natural gas contracts. As such, are such swaps considered "not in a physical marketing channel?" EPSA suggests that the Commission should clarify that such swaps hedging financial risk or other types of risks associated with physical contracts, such as those described above, should satisfy the hedge exemption and should not be considered when determining a market participant's status as a "Swap Dealer."

Accordingly, EPSA requests that the Commission permit parties to hedge both physical and financial risks associated with physical positions and that both types of hedges qualify as exemptions from the transactions counted in determining status as a "Swap Dealer."

C. The Commission Should Not Adopt Multiple Definitions of "Hedging" To Avoid Confusion and Increased Costs

The Commission requests comment about the costs and benefits of adopting a separate definition of hedging for purposes of determining one's status as a "Swap Dealer." The Commission notes in discussing the Interim Final Rule that the hedging exemption established here draws upon the principles of bona fide hedging used to identify financial instruments used for hedging purposes. In addition to the definition of hedging included in the Interim Final Rule and the definition of bona fide hedging upon which the Interim Final Rule draws, the

Commission has no less than three other definitions of “hedging” either in a Final Rule or in a Proposed Rule under the Dodd-Frank regulatory regime. As Commissioners Sommers and O’Malia noted in their official statements on this Interim Final Rule, the Commission did not adequately explain why the definition of hedging for “Swap Dealers” needs to be distinct from the definition of hedging as applied to end-users or major swap participants, or even distinct from the definition of bona fide hedging upon which the Interim Final Rule definition “draws the principles.”¹⁰

EPSA agrees with Commissioner O’Malia that a separate definition of hedging is unnecessary. EPSA members argue that multiple definitions of hedging will only lead to confusion about which definition applies under what circumstances. Additionally, multiple definitions of hedging will increase costs for entities in an attempt to navigate the confusing landscape of Dodd-Frank compliance when having to evaluate which circumstances exist and which definition of “hedging,” if any may apply. EPSA members are also concerned that, with multiple different definitions of “hedging” under the Dodd-Frank regulatory regime, proper compliance will be confusing at best and flawed at worst.

In addition to increased confusion and uncertainty, establishing multiple definitions of “hedging” will be very costly to market participants. EPSA members, who are end-users, will have to establish monitoring and reporting systems for the end-user hedging exception and will also evaluate the bona fide hedging definition under the position limits rule. They will incur unnecessary cost to develop a monitoring and reporting structure to evaluate hedging under the Interim Final Rule. The benefits of requiring yet another definition of hedging do not outweigh the costs necessary to comply with yet another definition of hedging.

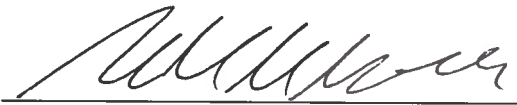
¹⁰ 77 Fed. Reg. 30762 (May 23, 2012.) (Statement of Commissioner O’Malia) and Opening Statement of Commissioner Jill E. Sommers, Twenty-Sixth Open Meeting to Consider Final Rules Pursuant to Dodd-Frank Act, <http://www.cftc.gov/PressRoom/SpeechesTestimony/sommersstatement041812>

IV. Conclusion

EPSA appreciates the Commission's consideration of our comments on the Interim Final Rule. For the reasons stated herein, we respectfully request that the Commission adopt the definition of hedging for physical positions with the above clarifications.

We are happy to discuss any comments further. Please feel free to contact EPSA at the number listed below if you have any questions regarding these comments.

Respectfully submitted,



Melissa M. Mitchell
Director of Regulatory Affairs and Counsel
Electric Power Supply Association
1401 New York Avenue, NW
Suite 1230
Washington, DC 20005
202-349-0151
mmitchell@epsa.org