DLA Piper LLP (US)
Mary Anne Mason
500 Eighth Street, NW
Washington, DC 20004
maryanne.mason@dlapiper.com
ph. (202) 799-4586
fax. (202) 799-5018

July 23, 2012

By Electronic Mail

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

RE: Further Definition of "Swap Dealer", etc. – Final Rule and Interim Final Rule Excluding Swaps Entered into for Hedging Physical Positions (CFTC Regulation § 1.3 (ppp)(6)(iii), 77 Fed. Reg. 30,596 (May 23, 2012)

Dear Mr. Stawick:

In the comments that follow, Southern California Edison Company ("SCE") responds to the Commodity Future Trading Commission's ("CFTC") request for comment on its Interim Final Rule ("IFR") setting forth the definition of hedging activity that may be excluded from dealing activity in a determination of whether an entity must register as a "Swap Dealer" under the Final Rule, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant"* (the "Entity Definition Final Rule" or "EDFR").

SCE responds in particular to the following specific CFTC requests for comments:

1. Whether a different approach to swaps entered into for the purpose of hedging risk is appropriate to implement the statutory definition of the term Swap Dealer;

2. Whether exclusion of hedging swaps from the Swap Dealer analysis is appropriate and, if so, how swaps that are entered into for purposes of hedging may be identified and distinguished from other swaps;

3. Whether it is relevant to distinguish swaps entered into for purposes of hedging from swaps that have a consequential result of hedging and, if so, how such swaps may be distinguished; and

4. Whether the exclusion should be limited to swaps hedging risks related to physical positions or extended to encompass swaps hedging financial risks or other types of risks.

See Entity Definition Final Rule at 30613-14.

A. Introduction of SCE.

SCE is an electric utility that provides electricity service to nearly 14 million people in central, coastal and southern California. SCE's business mission 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 energy to its customers. SCE purchases much of the electricity it provides to its retail customers from the wholesale electricity markets, and procures natural gas as fuel for the generating stations that it owns and those that has under contract.

SCE utilizes financial and non-financial derivatives solely to hedge and mitigate commercial risks related to its electricity service in order to provide a reliable and stable-priced electricity supply for its customers. SCE's electricity and natural gas transactions are subject to extensive regulation and oversight by the California Public Utilities Commission ("CPUC") and the Federal Energy Regulatory Commission ("FERC"), and it recovers the cost of such transactions through regulated retail rates.

B. Summary.

SCE believes the Entity Definition Final Rule is generally consistent with Congressional intent to regulate dealers, not commodity end users.[1] SCE is a regulated end user of energy commodities which is not in the business of making markets or accommodating demand for swaps. It should, therefore, be excluded from the limited number of entities required to register as Swap Dealers. The general definitional principles articulated in the EDFR support this result.[2] However, the EDFR also contains provisions under which SCE's derivatives activities could inappropriately be characterized as dealing, even though such activities are carried out in regulated, generally illiquid markets and SCE is prohibited from engaging in speculative activity.

Two aspects of the IFR raise potential concerns: (i) a safe harbor from the Swap Dealer determination that is limited to swaps hedging physical risk and (ii) a declaration that certain routine corporate risk management functions "generally constitute" dealing activities.[3] Although it

---

[1] *See* Joint Letter of Chairman Christopher Dodd and Chairwoman Blanche Lincoln stating "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 businesses." ….[The] Swap Dealer definition [] [is] not intended to include an electric or gas utility that purchases commodities that are used as a source of fuel to produce electricity … and that uses swaps to hedge or manage the commercial risks associated with its business." June 30, 2010 at 3.

[2] *See, e.g.,* statements asserting: (1) the CFTC estimates approximately 125 entities will be Swap Dealers; (2) the CFTC refers to ISDA "primary dealer" members as likely to be Swap Dealers under the rule; and (3) "when a person enters into a swap for the purpose of hedging the person's own risks in specified circumstances, an element of the swap dealer definition – the accommodation of the counterparty's needs or demands – is absent. Therefore, consistent with our overall interpretive approach to the definition, the activity of entering into such swaps (in the particular circumstances defined in the rule) does not constitute swap dealing." EDFR at 30710.

[3] *See, e.g.,* statements asserting: "any one of the following activities would generally constitute" dealing activities (referring to professional risk management infrastructure, including full-service in-house legal and credit departments, which are widely used to manage ordinary commercial risk). Id. a t 30610.

is clear that the CFTC's intent was to exclude entities like SCE from the category of "Swap Dealers," leaving these provisions as written could create an ambiguity where none was intended. To avoid this result, SCE requests that the CFTC modify and clarify the Interim Final Rule and the Entity Definition Final Rule in the following respects:

1. Revise the definition of Bona Fide Hedge to include swaps used to hedge an entity's own commercial, financial and regulatory risk.

2. Eliminate the requirement that only hedges representing "a substitute for transactions . . . in a physical marketing channel are excluded from the Swap Dealer determination."

3. Confirm that a "facts and circumstances" review to determine Swap Dealer status is not required for an entity that provides prior written notice to the CFTC that its derivatives transactions are subject to active state regulation that (a) prohibits speculative transactions; (b) authorizes derivatives transactions for the purpose of hedging risk to protect customer interests; and (c) prevents an entity from earning profit through its derivatives activities.

4. Clarify that an entity's use of a professional risk management infrastructure to support its commercial activities, including full-service in-house legal, credit and risk management departments, does not qualify it as a Swap Dealer unless the infrastructure is used to support a regular business of swap dealing.

5. Clarify that a Swap entered into in the good faith belief it will hedge a legitimate business risk will not be subject to *post hoc* review by the CFTC for effectiveness in the absence of other factors indicating failure of compliance.

C. Background: California's Regulated Electric Power Markets.

1. Evolution of the Regulatory Framework.

The regulatory framework that governs California power markets is the product of state and federal statutes and active CPUC and FERC regulation. The State instituted retail choice programs, required vertically-integrated utilities to separate generation from transmission and distribution and then divest much of that generation, and introduced a competitive market design for the sale of wholesale power. California requires that non-discriminatory access to the electricity grid be administered through operational control vested in the California Independent System Operator ("CAISO") and has made other arrangements to promote competitive market behavior. The State's regulatory framework is designed to deliver to consumers the benefits of competition, including efficiencies to be realized through financial innovations that enable trading in a variety of energy products. Such products were expected to enhance market liquidity, produce efficient pricing and dispatch, and provide accurate signals to induce efficient entry of generating capacity.

2. California Assembly Bill 57 and Pervasive Regulation by the CPUC of Long Term Power Procurement.

SCE's energy and natural gas procurement is governed by California Assembly Bill 57 ("AB 57"). Enacted in 2002, AB 57 was passed after the California energy crisis of 2000-2001 in an effort to protect SCE's customers from further financial harm associated with provision of electric service.

AB 57 mandates that SCE prepare Long Term Procurement Plans ("LTPPs") for review and approval by the CPUC. The LTPP aligns the business interests of SCE with those of its customers by requiring SCE to procure energy under the principle of "least cost, best fit" (consistent with satisfaction of system reliability and environmental standards and goals) and reducing the risk of adverse impacts from commodity price volatility.

Energy and natural gas transactions entered into by any California utility must be in accordance with its approved LTPP (or reviewed for reasonableness by the CPUC), and costs associated with transactions that conform to an approved LTPP, or that are separately approved by the CPUC, are recoverable through rates. To date, the CPUC has granted SCE approval to engage in certain transaction types: physical- and financially-settled spot and forward market purchases and sales of generation capacity, electricity, transmission, natural gas, pipeline capacity, storage, and regulatory and environmental compliance products. Under the LTPP framework, the CPUC regulates the power-related and natural gas procurement activity of SCE.

The CPUC recognizes the important role played by financial commodity derivative products in the efficient functioning of commodity markets. It also appreciates that economically-appropriate hedging activity can reduce price volatility and enable utilities to mitigate the commercial risks associated with commodity markets. When it approves an LTPP, the CPUC places specific limits on the utility's participation in commodity derivatives markets. The CPUC's review and approval of LTPPs and its review of power and natural gas procurement transactions is intended to prevent potential harm to California consumers from speculative activity that could undermine the financial stability of SCE. Thus, SCE already is subject to substantial regulatory oversight designed to avoid or minimize financial risk, and such regulation is congruent with, and supportive of, the CFTC's mandate to reduce systemic financial risk. More important, as noted above, such regulation precludes SCE from earning profits through its energy contracting activities, and all services must be provided to customers at cost.

D. Discussion of Specific Changes Requested

As explained above, because of the pervasive state regulatory scheme that applies to its businesses, SCE does not and cannot engage in swap dealing activities within the meaning of the Dodd-Frank Act. To the extent it uses derivative products, SCE does so solely to hedge and mitigate commercial risks, to protect its customers from price volatility in the energy commodities markets, to ensure reliability of service, to comply with environmental and economic regulatory requirements, and to manage other ordinary financial and commercial business risks. Nevertheless, certain of SCE's required power and natural gas procurement activities could be viewed in some respects as swap dealing activities. If SCE's hedging activities were subjected to the level of regulation that genuine Swap Dealers face, the IFR and the EDFR would impose burdens on SCE inconsistent with the intent of the Dodd-Frank Act. To avoid this result, SCE requests the CFTC to clarify the IFR and EDFR as described below.

(a) Revise the definition of Bona Fide Hedge to include Swaps used to hedge an entity's own commercial, financial and regulatory risk and eliminate the requirement that only physical hedges are excluded from the Swap Dealer determination.

The IFR proposes a five-part test for excluding swaps entered into for hedging physical positions. CFTC Regulation §1.3(ppp)(6)(iii) provides:

> In determining whether a person is a swap dealer, a swap that the person enters into shall not be considered, if:

> (A) The person enters into the swap for the purpose of offsetting or mitigating the person's price risks that arise from the potential change in the value of one or several (1) assets that the person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising; (2) liabilities that the person owns or anticipates incurring; or (3) services that the person provides, purchases, or anticipates providing or purchasing;
>
> (B) The swap represents 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;
>
> (C) The swap is economically appropriate to the reduction of the person's risks in the conduct and management of a commercial enterprise;
>
> (D) The swap is entered into in accordance with sound commercial practices; and
>
> (E) The person does not enter into the swap in connection with activity structured to evade designation as a swap dealer.

SCE believes it is appropriate to exclude all of its hedging activity from Swap Dealer status determinations because "entering into a swap for the purpose of hedging is inconsistent with swap dealing." EDFR at 30611. As explained, SCE engages solely in hedging activities for the benefit of its customers and is prevented by State regulation from speculative trading of derivatives. SCE's derivatives transactions must conform to a CPUC-approved LTPP. Its performance under the LTPPs is subject to post hoc review to verify, inter alia, whether risk management and power and natural gas supply portfolio requirements have been satisfied. The CPUC's review also is designed to ensure that SCE remains financially capable of providing essential energy services to its customers. Accordingly, SCE's hedging activities should be excluded from the definition of Swap Dealing, without regard to whether the hedges are deemed purely "physical."

SCE believes the CFTC has ample authority to ensure regulation of actual swap dealing activities by Swap Dealers without subjecting all but swaps that can be classified as a "substitute for a physical position" to an uncertain regulatory status. SCE urges the CFTC to revise its definition of Bona Fide Hedge to extend the hedging safe harbor to include all swaps entered in the good faith belief that they will hedge an entity's own business risk, including regulatory risk, whether or not the risk hedged is a substitute for a physical position.

(b) Confirm that a "facts and circumstances" review to determine Swap Dealer status is not required for an entity that provides prior notice to the CFTC that its derivatives transactions are subject to active state regulation that (a) prohibits speculative transactions; (b) authorizes derivatives transactions for the purpose of hedging risk to protect customer interests; and (c) prevents an entity from earning profits through its derivatives activities.

Although the CFTC acknowledges that the Swap Dealer definition is intended to reach fewer than 200 entities, a safe harbor limited to physical substitute hedges would potentially subject thousands of commercial entities to regulatory uncertainty to the extent they use non-physical hedges to manage commercial, financial and regulatory risk. The CFTC provides no guidance on

how it would determine whether transactions that fall outside the IFR definition of physical substitute hedges but within the definition of hedging or mitigating commercial risk are either more or less likely to constitute swap dealing activities. SCE submits that a requirement to analyze the purpose of all hedges is unlikely to yield additional Swap Dealer registrants who would not otherwise have been required to register under the EDFR. The *de minimis* risk that actual swap dealers could avoid registration through the use of swaps that are not a substitute for a physical position does not warrant the imposition of a "facts and circumstances" analysis on commodity end users. Such an analysis would sweep in a wide range of commercial transactions routinely used to hedge commercial risk without achieving appreciable improvements in compliance with swap dealer registration requirements.[4]

Instead, SCE requests that the CFTC determine that regulated entities, like SCE, be excluded from being deemed Swap Dealers because they are precluded by regulation from serving as for-profit swap dealers within the meaning of the EDFR and they are subject to regulatory oversight intended to ensure financial stability.

(c) There is No Need to Distinguish Hedging Swaps From Those With A Consequential Hedging Result

The CFTC has asked whether it is appropriate to distinguish "hedging" swaps from swaps with a "consequential hedging result."[5] SCE believes it is unnecessary to distinguish a "hedging purpose" from a "hedging consequence" of non-physical swaps. The EDFR definition of Swap Dealer, together with the CFTC's interpretive guidance, provide a comprehensive road map to the analytical steps that implement the four statutory tests for dealing activities. An additional costly and time-consuming inquiry into the purpose of a given swap is unnecessary.[6] SCE urges the CFTC instead to take a principle-based approach to the definition of Bona Fide Hedge under which the definition of Bona Fide Hedge includes swaps (i) used to hedge an entity's own commercial, financial and regulatory risks in the good faith belief that the swaps will hedge such risks and (ii) not entered as part of a profit-seeking dealing business.

(d) Additional aspects of Swap Dealer Definition

SCE interprets the EDFR to be intended to reach only entities in the business of swap dealing who are engaged in the making of markets and the accommodation of customer demand for profit. This core definition of a Swap Dealer is entirely appropriate and should not capture end users like SCE. As a general matter, the discussion in the EDFR supports this core interpretation. Notably, the CFTC refers to ISDA "primary dealer" members as likely to be swap dealers under the rules. ISDA reports having 200 current primary members, and elsewhere in the rulemaking "the CFTC estimates that approximately 125 entities will be covered by the definitions of the terms "swap

---

[4] The CFTC states that it "expect[s] that the number of persons covered by the [Swap Dealer] definition will be very small in comparison to the thousands of persons that use swaps for hedging."

[5] In connection with the IFR, the CFTC says: "The practical difficulty lies in determining when a person has entered into a swap for the purpose of hedging, as opposed to other purposes for entering into swaps, such as accommodating demand for swaps or as part of making a market in swaps, and in distinguishing a swap with a hedging purpose from a swap with a hedging consequence." IFR at 30612. "[N]o method has yet been developed to reliably distinguish, through a per se rule, between: (i) swaps that are entered into for the purpose of hedging or mitigating commercial risk; and (ii) swaps that are entered into for the purpose of accommodating the counterparty's needs or demands or otherwise constitute swap dealing activity, but which also have a hedging consequence." Id at 30613.

[6] EDFR at 30606-07.

dealer" and "major swap participant." Thus, there is much in the EDFR to support the proposition that the final rule covers as Swap Dealers those entities one would expect to see labeled as such, namely a subset of the principal membership of a trade association formerly named the International Swap Dealers Association, and not SCE. Nevertheless, certain aspects of the EDFR could lead to an inconsistent result. Specifically, the EDFR states:

> Any one of the following activities would generally constitute both entering into swaps "as an ordinary course of business" and "as a part of a regular business": . . . having staff and resources allocated to dealer-type activities with counterparties, including activities relating to credit analysis, customer onboarding, document negotiation, confirmation generation, requests for novations and amendments, exposure monitoring and collateral calls, covenant monitoring, and reconciliation.

This language suggests that a professional risk management infrastructure, including full-service in-house legal, risk management and credit departments, can qualify one as a Swap Dealer. SCE believes the Dodd Frank Act was not intended to regulate as Swap Dealers all entities with a risk management infrastructure, but a literal reading of the statement "any one of the following activities would generally constitute" swap dealing activities could lead to such a result. Risk management infrastructures are necessary corporate functions for SCE and are used to manage market activities related to protecting retail electric customer interests, which includes acting as a highly informed "customer" of swap dealers. If implemented as written, the cited language could discourage sound risk management and increase systemic risk.

SCE requests the CFTC to clarify its discussion of risk management infrastructure to indicate that an entity's use of a professional risk management infrastructure to support its commercial activities, including full-service in-house legal and credit departments, does not alone qualify it as a Swap Dealer unless such infrastructure is linked to, and used primarily for, the regular business of swap dealing.

(e) Post-hoc review of the effectiveness of hedges.

The EDFR directs the CFTC and SEC staffs to report on whether the continued availability of the hedging exclusion should be conditioned on assessment of hedging effectiveness and related documentation.[7] Hedging effectiveness would be determined based on whether a transaction is "economically appropriate" or "entered into with sound commercial practices." SCE is concerned that such post-hoc review (1) will chill legitimate hedging to the detriment of cost-effective risk management in support of utility procurement, (2) will add a layer of congruent (but potentially inconsistent) regulation to transactions already subject to pervasive regulation that bans trading for speculative profit, and (3) waste administrative resources on activities that are obviously not part of the business of making markets or of accommodating customer demand for profit.

These concerns are supported by the arguments set forth above. Further, where hedging cannot be undertaken for profit, the additional risk of unforeseen transaction costs attendant to retroactive review would certainly affect a utility's willingness to undertake otherwise beneficial risk management through trading. In this way, such review could in fact thwart the objectives of utility regulation. Therefore, the CFTC should not second-guess the CPUC by evaluating whether any particular swap entered into pursuant to the authority granted to SCE by the CPUC and

[7] *See, e.g.,* EDFR at 30680.

subject to its review and enforcement is "economically appropriate" or "entered into with sound commercial practices" and hence not a Bona Fide Transaction.

(f) Regulatory exemption.

The definitional complexities and associated regulatory uncertainty described above are avoidable through the implementation of carefully-tailored exemptions for regulatory products (in the case of the Product Definition Rule) and for transactions subject to regulatory oversight for the avoidance of speculation (in the case of the Entity Definition Final Rule). Within the framework of the EDFR, SCE requests the CFTC to confirm that a "facts and circumstances" review of an entity's derivatives transactions is not necessary in the case of certain highly regulated entities, such as SCE, and that such entities are presumed not to hold Swap Dealer status provided they provide the CFTC with prior written notice that they are subject to state regulation which (a) oversees and restricts speculative derivatives activities; (b) authorizes and reviews hedging activity to protect customer interests; (c) prevents an entity from earning profits through its derivatives activities; and (d) does not authorize dealing activity.

SCE believes this approach to determination of Swap Dealer status is appropriate because the CPUC regulates the prudency of its transactions and determines whether its costs are recoverable in electric service rates. Therefore, SCE should not be faced with the prospect of the CFTC second-guessing the CPUC, and determining that any particular swap, even if entered into in accordance with a CPUC-approved LTTP, is not "economically appropriate" or "entered into with sound commercial practices" and hence a swap to be counted towards determining whether SCE is a Swap Dealer. Nor should the CPUC be faced with adverse consequences to it and the retail customers it protects as a result of an after-the-fact CFTC determination that a transaction authorized by the CPUC is not "economically appropriate."

SCE appreciates the opportunity to provide the foregoing comments.

Respectfully submitted,

Mary Anne Mason

Mary Anne Mason of DLA Piper LLP (US)
On Behalf of Southern California Edison Company