The Potential Impact of Dodd-Frank on the Energy Industry

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In a dramatic demonstration of Congressional "Fire, Ready, Aim" and fully six-months before the scheduled report of the specially-charged Financial Crisis Investigation Commission, President Obama signed the Dodd-Frank Act into law in July last year.[1] While nominally addressing perceived causes of the recent financial crisis, the Dodd-Frank Act is a sprawling piece of legislation, directed at literally hundreds of different aspects of the financial system. The full text of the Act itself runs to nearly 850 pages, including 17 separate Titles, and has eleven pages of single-spaced table of contents alone. The breadth of the legislation itself does not include the over 300 separate reports, studies and rulemakings from over 13 separate federal agencies, the vast majority of which are required by July 15, 2011. There is rather a lot of law here, to put it mildly.

Even though the Act focuses mainly on financial institutions and the financial system, the effects of the Act will be felt throughout the economy at large and will be experienced by non-financial market participants. In this last respect, Dodd-Frank will have potentially significant consequences for energy companies and investors therein and related markets for energy goods and services. Financial institutions active in the energy sector no doubt have a lead on others in digesting the Act and assessing its impact on their activities. In our experience, non-financial institutions in the energy sector have some catching up to do. Because of this gap, and because it would exceed the space allowed to do otherwise, we are going to focus on the potential impact of Dodd-Frank on energy companies and energy markets generally.

Generally, the purpose of Dodd-Frank is to reduce systemic risk, increase transparency of the financial markets, and promote market integrity. Most likely, Dodd-Frank will affect energy companies in connection with their power marketing, hedging, and trading activities – in other words in connection with "swaps". The swap requirements of Dodd-Frank will range up and down a sliding scale depending on the firm's activities and the outcome of a federal rule-making process many months from completion. Those requirements may be glancing blows that increase the cost of hedging honest commercial risk (energy prices or interest on debt, for example) to full-on regulation and inspection by the Commodities Futures Trading Commission or the Securities and Exchange Commission. Title VII of the Dodd-Frank Act is called the Over-the-Counter Derivatives Reform and Transparency Act and covers "swaps" and To establish a comprehensive regulatory framework to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things (and in the Commodity Futures Trading Commission's own words): "(1) Providing for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposing clearing and trade execution requirements on standardized derivative products; (3) creating rigorous recordkeeping and real-time reporting regimes; and (4) enhancing the Commission's rulemaking and enforcement authorities with respect to all registered entities and intermediaries subject to the Commission's oversight."

The Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) have primary rulemaking authority over the swap provisions of Dodd-Frank and are required to make certain rulemakings jointly (either irony or wryly amusing to those who have experienced the occasionally open hostility of these two agencies to one another) and to generally consult with each other and with the US Treasury and others in their individual rulemakings. The jurisdictional boundaries between the CFTC and the SEC are based on whether a transaction is a "swap" or a "security-based swap". Security-based swaps are based on a security, loan or a "narrow" security index. The SEC has authority over "security-based swaps". The CFTC has authority over all other "swaps", including in all likelihood those most relevant to the energy industry. Congress expected the CFTC and the SEC to work together to produce harmonious rules, but already there has been some marked divergence.

As noted, Congress intended Dodd-Frank to become effective generally on July 15, 2011 (although some specific provisions have longer timelines for their respective effectiveness) and, where rulemaking by an agency is required, 60 days following that rulemaking. Hundreds of provisions in Dodd-Frank require rulemaking, and already several federal agencies are admittedly months, even up to a year, behind schedule. Even those federal agencies that are (or are close to being) on schedule have drawn sharp criticism for the fast pace (precluding consultation and careful deliberation regarding required rules) and lack of coordination (precluding or limiting effective participation by those affected or at risk of being affected) of their rulemaking activities. CFTC regulations on swaps were initially expected in early 2011. However, the CFTC in January 2011 announced it expected to conclude its rulemaking process in early 2012. It is an open secret that the complexity of the markets coming under regulation strains available agency personnel and existing regulatory concepts. The interrelatedness of the rules proposed and yet to be proposed is only a further complication.

Side-by-side markets for over-the-counter (OTC) and exchange-traded energy "swaps" have existed for years and, since the enactment of the Commodity Futures Modernization Act in 2000, without much regulation or oversight of the OTC energy derivatives markets. So exactly who and what will be regulated under Dodd-Frank? To some extent, and with only slight exaggeration, everyone involved with swaps and every swap transaction will be regulated. In a sign of how far we have to go, federal rulemaking has not yet finalized the definition of "swap", although the Dodd-Frank Act includes a broad definition (some say overly–broad) and requires a joint rulemaking by the CFTC and the SEC to further define "swap". In fact, no proposed rule to further define "swap" has yet been issued. Subject to the rulemaking process and a finite list of specific exclusions, under Dodd-Frank a swap will be any obligation based on a contingency, other than forward sales that are intended to be physically settled. (Indeed, the detailed list of activities caught up in the definition for "swap" includes the coverall "an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap."[2])

When all is said and done, all swaps (including all swaps on a firm's books as of Dodd-Frank's enactment) will have to be reported, either through an exchange/ clearinghouse or self-reported to a "swap data repository" under an end-user exception to the mandatory clearing requirement or because the swap is not traded on an exchange/cleared by a clearinghouse. The default mandatory requirement to clear all swaps through an exchange/clearinghouse mechanism would almost certainly subject firms irregularly hedging commercial risk to unaccustomed margining requirements, perhaps requiring daily margin calls, and to the resulting call on the firm's liquidity (margin must usually be cash or cash equivalents). Because of that implication, many of those providing comments to the CFTC's proposed rules have focused on the end-user exception to the clearing requirement.

If a firm can take advantage of the end-user exception, the swap does not need to be cleared as described. It must still be reported to the CFTC along with specified information about the end-user. The end-user exception imposes a number of requirements, including:

1) The trade must hedge or mitigate commercial risk;
2) One party to the trade (in our hypothetical, the energy firm) cannot be a financial entity (generally, an institution subject to any one of a number of federal banking, broker/dealer, and investment company regulations);
3) In connection with reporting the trade in question, the party that is not a financial entity must report to the CFTC how it meets its financial obligations for trades that are not cleared (Recall that the end-user exception merely relieves the obligation to clear the trade through a clearinghouse);
4) SEC filers claiming the end-user exception must have board approval for the non-cleared trade.

Each trade for which the end-user exception is elected must be reported. The report must include information about the firm and, as we say, how the firm meets its financial obligations for trades that are not cleared. The information required in this regard includes whether the firm has credit support, has pledged or segregated assets, intends to rely solely on available resources, has a guaranty from some other entity or has other means of satisfying its financial obligations in connection with un-cleared trades.

Our strong hunch is that most firms will shrink from the burden and cost of these reporting requirements and, other than in connection with the most valuable bespoke trades for which no clearing mechanism exists, simply take their lumps and pay the incremental cost of executing the trade through a clearinghouse and bear the cost and hassle of margining.

Under Dodd-Frank, forward contracts that are intended to be physically settled are excluded from "swaps". Accordingly, a traditional power purchase agreement that provides for physical settlement should not need to be cleared or reported. Most likely, typical "book-out" (agreeing to a financial settlement instead of required physical settlement) will not cause a power purchase agreement to become a "swap" even though the contract is not in fact physically settled. It is an open question, and a serious one, whether power purchase agreements for delivery within ISO regions that act as brokers for all trades, such as NY ISO, will qualify as "intended to be physically settled." It is also not clear yet whether REC contracts qualify as swaps (are they "emission" swaps or something else?). Industry groups have asked the relevant government agencies to exclude them, but as with most of Dodd-Frank's swap regulations, the government has yet to produce a final rule Similarly, emission allowance swaps (that are specifically identified as "swaps" in Dodd-Frank) raise the "physically-settled" question (since there may be no "physical" to actually settle), although various industry groups have urged the CFTC to include them in the exclusion. Finally, there are a number of potential "swaps," – e.g., financial transmission rights, auction revenue rights and others that have been specifically created or authorized by the US Federal Energy Regulatory Commission (FERC) as part its opening of energy markets to wholesale competition, where CFTC regulatory oversight was not expected, would be intrusive on existing and established FERC authority, and would risk substantial burden without obvious economic or other benefit. Notably, a required memorandum[3] to Congress from both the CFTC and FERC regarding the demarcation of their respective regulatory authorities is now several months' overdue.

Significant players in the energy swap markets are likely to be the most highly regulated – including reporting, business conduct and capital requirements. These entities will themselves be regulated, as opposed to the regulation of any particular energy trade. These affected players will be "swap dealers," "major swap participants," clearinghouses, exchanges and data repositories. Of course, regulation of clearinghouses and exchanges predates Dodd-Frank, but these will now be subject to increased oversight and regulation. So-called "swap execution facilities" and "swap data repositories" are new statutory creatures, created by Dodd-Frank, and are generally intended to facilitate market transparency. Swap dealers (SDs) will be generally defined by their activities. SDs are market makers, accommodate trades, and generally stand on both sides of trades. Major swap participants (MSPs) will be defined by a proposed arithmetic formula. The MSP rules are designed to catch big players like AIG, firms holding billion dollar and more trades and substantial swap exposures. As with the rest of Dodd-Frank in this area, the CFTC and SEC are still working on the rules that will provide final rules and guidelines for these entities.

Despite these significant unknowns, we feel confident in saying that most energy companies should not be regulated as SDs or MSPs and will almost certainly not find themselves to be unexpected clearinghouses, exchanges, swap execution facilities or swap data repositories. On the one hand, it should be quite clear to an energy firm that its hedging and trading activities propel it into the stratosphere of players caught up by the SD or MSP rules. Any firm whose trading activities are at those MSP-type levels should already be aware of it and will have to monitor the Dodd-Frank rule-making process. The rules regarding SD status will be slightly more ambiguous. Firms will have to monitor their respective personnel and the conduct and activities thereof more closely to ensure they do not unintentionally cross the line once established by final rule. ◆

Endnotes

1 The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203).

2 Dodd-Frank Act § 721(a)(21).

3 Dodd-Frank Act §720(a)(1).