July 11, 2011

VIA ELECTRONIC SUBMISSION

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20851

Re: Comments on the Proposed Rules on Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (RIN 3038-AC97) and Capital Requirements for Swap Dealers and Major Swap Participants (RIN 3038-AD54)

The Edison Electric Institute ("EEI"), the Electric Power Supply Association ("EPSA"), the National Rural Electric Cooperative Association ("NRECA"), the American Public Power Association ("APPA"), the Large Public Power Council ("LPPC"), and the American Gas Association ("AGA") (hereafter "Joint Associations")[1] respectfully submit these comments in response to the proposed rules regarding Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants ("Proposed Margin Rule")[2] and Capital Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants ("Proposed Capital Rule" and collectively, the "Proposed Rules")[3] issued by the Commodity Futures Trading Commission ("CFTC" or "Commission"). The Joint Associations have been active participants in many aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") implementation process and welcome the opportunity to continue to discuss commercial end user-related issues with the Commission and staff.

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[1] The comments contained in this filing represent the position of the Joint Associations, but not necessarily the views of any particular member of the Joint Associations with respect to any issue. The Joint Associations are authorized to note the involvement and support of these comments and recommendations from the Transmission Access Policy Study Group (an association of transmission dependent electric utilities located in more than 30 states), ACES Power Marketing, and The Energy Authority.

[2] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (April 28, 2011).

[3] Capital Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27,802 (May 12, 2011).

The Joint Associations' support the Commission's proposal allowing swap dealers and major swap participants ("MSPs") that transact with commercial end users to continue to negotiate the terms of their swaps free from any mandatory minimum margin rules and instead to allow bilaterally negotiated credit support arrangements. This aspect of the Commission's proposal is consistent with Congress' intent, as reflected in the Dodd-Frank Act, to provide commercial end users with broad exemptions from the new registration and clearing requirements of the Commodity Exchange Act, as amended ("CEA") applicable to swaps and certain participants in the swap markets. However, the Joint Associations' respectfully request that the Commission: (1) revise the Proposed Capital Rule to more accurately reflect of the lower risk associated with commercial end user transactions by permitting swap dealers and MSPs to assign a significantly lower credit risk factor to commercial end users without requiring a formal application or pre-approval; and (2) eliminate from the Proposed Margin Rule the prescriptive swap documentation, collateral valuation, specific swap exposure calculations and other credit risk management requirements for swaps with commercial end users. The Joint Associations respectfully submit that these proposed revisions will ensure that the end user clearing exception will serve as a cost-effective and commercially practical means for end users to continue to use swaps to hedge or mitigate their commercial risk.

I. Description of the Joint Associations and their Interest in the Proposed Rules

EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 95 percent of the ultimate customers in the shareholder-owned segment of the U.S. electricity industry, and represent approximately 70 percent of the U.S. electric power industry. EEI also has more than 65 international electric companies as Affiliate members, and more than 170 industry suppliers and related organizations as Associate members.

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.

Formed in 1942, NRECA is the national service organization for more than nine hundred rural electric utilities and public power districts that provide electric energy to approximately forty-two million consumers in forty-seven states or twelve percent of the nation's population. Kilowatt-hour sales by rural electric cooperatives account for approximately eleven percent of all electric energy sold in the United States. Because its electric customers are members of the cooperative, the cooperative operates on a not-for-profit basis and all the costs of the cooperative are directly borne by its consumer-members.[4]

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[4] 13 C.F.R. § 121.201, n.1. The vast majority of NRECA's members meet the definition of "small entities" under the Small Business Regulatory Enforcement Fairness Act. Only four distribution cooperatives and approximately

APPA is the national service organization representing the interests of government-owned electric utilities in the United States. More than two thousand public power systems provide over fifteen percent of all kilowatt-hour sales to ultimate customers. APPA's member utilities are not-for-profit utility systems that were created by state or local governments to serve the public interest. Some government-owned electric utilities generate, transmit, and sell power at wholesale and retail, while others purchase power and distribute it to retail customers, and still others perform all or a combination of these functions. Government-owned utilities are accountable to elected and/or appointed officials and, ultimately, the American public. The focus of a government-owned electric utility is to provide reliable and safe electricity service, keeping costs low and predictable for its customers, while practicing good environmental stewardship.[5]

The Large Public Power Council is an organization representing twenty-four of the largest government owned and operated public power systems in the nation. LPPC members own and operate over 75,000 megawatts of generation capacity and nearly 34,000 circuit miles of high voltage transmission lines. Collectively, LPPC members own nearly ninety percent of the transmission investment owned by non-federal government-owned electric utilities in the U.S. LPPC member utilities supply power on a not-for-profit basis to some of the fastest growing urban and rural residential markets in the country. Members are located in eleven states and Puerto Rico and provide power to some of the largest cities in the country, including Los Angeles, Seattle, Omaha, Phoenix, Sacramento, Jacksonville, San Antonio, Orlando, and Austin.

The AGA, founded in 1918, represents 201 local energy companies that deliver clean natural gas throughout the United States. There are more than 70 million residential, commercial and industrial natural gas customers in the United States, of which 91 percent — more than 64 million customers — receive their gas from AGA members. AGA is an advocate for local natural gas utility companies and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international gas companies and industry associates. Today, natural gas meets almost one-fourth of the United States' energy needs.

The Joint Associations' members are not financial entities. Rather, they are physical commodity market participants that rely on swaps primarily to hedge and mitigate commercial risk. Regulations that make effective risk management options more expensive for commercial end users of swaps will likely lead to higher energy prices if the costs associated with new regulations are passed through to energy consumers, or will result in more volatile prices if commercial end users decide to hedge a smaller portion of their commercial risk using swaps. Accordingly, as end users of commodity swaps to hedge commercial risk, the Joint Associations'

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twenty-eight generation and transmission entities do not meet the definition. The Regulatory Flexibility Act incorporates by reference the definition of "small entity" adopted by the Small Business Administration (the "SBA"). The SBA's small business size regulations state that entities which provide electric services are "small entities" if their total electric output for the preceding fiscal year did not exceed four million megawatt hours.

[5] Most of APPA's members also meet the definition of "small entities" under the Small Business Regulatory Enforcement Fairness Act.

members have a direct and significant interest in capital and margin requirements that may adversely affect the end user clearing exception.

II. Summary of the Joint Associations' Comments

The Joint Associations respectfully request that the Commission revise the Proposed Rule to:

- Establish capital requirements for swap dealers and MSPs that reflect the different levels of risk posed by different categories of swaps and swap market participants and, thereby, protect commercial end users from higher indirect costs that swap dealers and MSPs may pass along to their counterparties; and

- Allow commercial end users and their swap counterparties to negotiate mutually agreeable credit support arrangements rather than requiring them to comply with CFTC-specified documentation and related credit support requirements.

III. Capital Requirements for Swap Dealers and MSPs that Reflect the Specific Levels of Risk Posed by Different Categories of Swaps and Swap Market Participants will Protect Commercial End Users from Unnecessary Higher Costs.

CEA Section 4s(e)(3)(A) states that capital requirements for swap dealers and MSPs must serve to "ensure the safety and soundness of the swap dealer or [MSP]" and be "appropriate to the risk associated with the non-cleared swaps" held by the swap dealer or MSP.[6] However, the risk associated with any particular non-cleared swap varies depending on the individual characteristics of the transaction and the counterparty. Non-financial commodity swaps entered into by commercial end users for the purpose of hedging or mitigating commercial risk pose little risk to their counterparties or the market as a whole. In fact, because commercial end users rely on swaps to *reduce* commercial risk, their hedging transactions *increase* the stability of the swaps market and the broader financial system.[7]

The Joint Associations are concerned that even though the Commission has proposed rules that would not impose capital requirements on commercial end users *directly*, if swap dealers and MSPs are subject to capital requirements that do not reflect the relatively low risk associated with most commercial end user swaps, the cost of complying with these requirements

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[6] CEA Section 4s(e)(3)(A)(ii).

[7] *See* 156 Cong. Rec. H5244-45 (daily ed. Jun. 30, 2010) (statement of Rep. Peters) ("[B]ecause commercial end users, who are those who use derivatives to hedge legitimate business risks, do not pose systemic risk and because they solely use these contracts as a way to provide consumers with lower cost goods, they are exempted from clearing and margin requirements.")

may be passed through to and imposed on commercial end users *indirectly*.[8] Proposed Rule 23.104(e)(1)(ii) provides that unless a swap dealer or MSP applies for and receives permission to use an internal credit risk weighting system, every swap dealer and MSP will be required to use the same "credit risk factor" (*i.e.*, 50 percent) for all of its swap activity, regardless of the individual credit risk associated with each counterparty.[9] As a practical matter, this provision would result in unnecessarily high capital charges associated with commercial end user swaps.

The Proposed Capital Rule should protect commercial end users from higher direct *and indirect* costs by modifying the Proposed Capital Rule to allow swap dealers and MSPs to assign a significantly lower credit risk factor to commercial end users without requiring a formal application or pre-approval.[10] The likelihood of a default on a swap between a swap dealer or MSP and a commercial end user is relatively low because any losses associated with an end user swap will typically be offset by a change in the position or commercial risk associated with the end user's underlying business that is being hedged (*i.e.*, when an end user's swap exposure increases, the hedged exposure usually decreases proportionally).[11] Moreover, the Proposed Rules should provide for these lower credit risk factor categories for swaps with commercial end users because requiring the Commission staff to review the wide variety of ways that swap dealers and MSPs assign internal credit ratings to each counterparty with which it transacts in swaps would impose a substantial burden on the CFTC's resources that is unnecessary, at least with respect to commercial end users that use swaps primarily to hedge risk.[12]

As Senator Dodd emphasized: "[i]t is . . . the intent of this bill to distinguish between commercial end users hedging their risk and larger, riskier market participants. Regulators should distinguish between these types of companies when implementing new regulatory

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[8] Question No. 12 in the Proposed Capital Rule states, "[w]hat are the costs to counterparties resulting from the capital requirements being proposed by the Commission?" 76 Fed. Reg. at 27,818. This section responds to the Question No. 12.

[9] 76 Fed. Reg. at 27,834-35.

[10] *Id.* For example, the Commission could authorize swap dealers and MSPs to use the lower "credit risk factor" (*i.e.*, 20 percent) contemplated in Proposed Rule 23.104(e)(1)(iii) without prior approval for swaps with commercial end users, and an even lower credit risk factor for particularly low risk entities that engage in swaps *solely* to hedge or mitigate commercial risk. As a practical matter, this would result in capital requirements that are "comparable" to the risk-based capital requirements already established by the Prudential Regulators and, therefore, the requirements of CEA Section 4s(e)(3)(D) which require the Prudential Regulators and the CFTC to "establish and maintain comparable minimum capital requirements" to the maximum extent practicable. CEA Section 4s(e)(3)(D).

[11] In addition, in the electric and gas industries, commercial end users receive a predictable revenue stream from consumers and have valuable tangible assets to provide credit support for their commercial activities. As Rep. Peters explained, commercial end users who use derivatives to hedge legitimate business risks should be exempt from margin requirements because "they *do not pose systemic risk* and because [end users] . . . use these contracts as a way to provide consumers with lower cost goods." 156 Cong. Rec. H5244-45 (daily ed. Jun. 30, 2010) (statement of Rep. Peters) (emphasis added); s*ee also*, 156 Cong. Rec. H5230 (daily ed. Jun. 30, 2010) (statement of Rep. McMahon) ("These end-user companies pose little or no systemic risk to our economy, and this bill protects them from unnecessary and burdensome margin and clearing requirements.").

[12] 76 Fed. Reg. at 27,835.

requirements."[13] Similarly, Senator Debbie Stabenow and Representative Frank Lucas noted in a June 20, 2011 letter to the CFTC, it is Congress's intent for the regulators "to ensure that any new capital requirements are carefully linked to the risk associated with the uncleared [commercial end user] transactions, and not used as a means to deter over-the-counter trading."[14] It is appropriate and consistent with Congress' intent for the Commission to adopt a flexible, risk-based capital rule that allows swap dealers and MSPs to treat non-financial commodity swaps entered into with commercial end users as lower risk transactions for purposes of calculating swap dealer and MSP capital requirements.[15]

IV. The CFTC Should Improve the Proposed Margin Rule by Allowing Commercial End Users to Comply with Bilaterally Negotiated Credit Support Arrangements that are not Subject to Prescriptive Documentation Regulations.

A. *The Commission correctly refrained from adopting margin requirements that apply to commercial end users.*

The Joint Associations support the Commission's decision not to adopt margin requirements that apply directly to commercial end users. As Senator Lincoln explained: "[i]t is clear in this legislation that the regulators only have the authority to set capital and margin requirements on swap dealers and [MSPs] for uncleared swaps, not on end users who qualify for the exemption from mandatory clearing."[16] Similarly, as Chairman Gensler noted at the CFTC's April 12, 2011 public meeting, "[t]he proposed rule would not require margin to be paid or collected on transactions involving non-financial end-users hedging or mitigating commercial risk [because] [t]ransactions involving non-financial entities do not present the same risk to the financial system as those solely between financial entities."[17] The Joint Associations agree. Imposing margin requirements on commercial end users is inconsistent with Congress' expressed intent regarding the end user exception and, when read in context, the language of the Dodd-Frank Act.[18]

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[13] 156 Cong. Rec. S5904 (daily ed. Jul. 15, 2010)(statement of Sen. Dodd).

[14] June 20, 2011 Letter from Sen. Stabenow and Rep. Lucas at 3.

[15] In addition, unlike futures, each party to a swap knows its counterparty's identity. When a swap dealer or MSP is calculating its capital requirements, it should be able to take its counterparty's identity into account by assigning a lower credit risk factor for transactions involving lower risk counterparties.

[16] 156 Cong. Rec. S5904 (daily ed. Jul. 15, 2010) (statement of Sen. Lincoln); *see also* June 20, 2011 Letter from Sen. Stabenow and Rep. Lucas at 3 (noting the "clear congressional intent" not to impose margin requirements on commercial end users).

[17] 76 Fed. Reg. at 23,748-49.

[18] In a parallel rulemaking, Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Farm Credit Administration (the "Prudential Regulators") proposed regulations that could require swap dealers and MSPs to collect margin from commercial end users in certain circumstances. Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (May 11, 2011). In support of this proposed rule, the Prudential

B. *The Proposed Margin Rule correctly permits swap dealers and MSPs to accept a wide-variety of non-cash collateral from their commercial end user counterparties.*

The Joint Associations support the Commission's decision to allow swap dealers and MSPs to enter into credit support arrangements with commercial end users that permit the use of most forms of non-cash collateral. Permitting the use of many forms of credit support, including non-cash collateral, is consistent with Congress' expressed intent and the plain language of the Dodd-Frank Act.[19] Moreover, the use of non-cash collateral allows commercial end users to continue to use swaps to hedge risk in a cost-effective and commercially practicable manner.

Many commodity market participants rely on a wide range of credit support, including mortgages and other liens on physical assets, letters of credit, pledges of stock, payment guarantees, deposit accounts or cash management agreements, and other arrangements to provide credit support for their swap transactions. In the energy industry, swaps (and the non-financial commodity transactions they hedge) often are unsecured or secured by credit support that would not satisfy narrowly defined cash and cash-equivalent collateral requirements (*e.g.*, the Prudential Regulators' proposed margin requirements).[20] For example, utilities and other energy market participants often rely on their highly-reliable source of cash flow (*i.e.*, payments from retail energy consumers) and valuable tangible assets (*i.e.*, power plants) as much as or more than formal credit support arrangements and posted collateral to support their payment obligations on swaps. Although these credit support arrangements are not analogous to the dollar-for-dollar margin commonly used in cleared transactions or transactions between financial entities, commercial end users have a well-established history of using a combination of unsecured credit and various forms of credit support responsibly in the course of their ongoing relationship, and in a manner that reduces commercial risk and promotes the stability of the United States financial system.

Regulators explained that "[t]he plain language of section[s] 731 and 764 provides that the [Prudential Regulators] adopt rules for covered swap entities imposing margin requirements on *all non-cleared swaps*. Those sections do not, by their terms, exclude a swap with a counterparty that is a commercial end user." 76 Fed. Reg. at 27,569 (emphasis original). The Joint Associations respectfully disagree. CEA Section 4s(e)(2)(B) authorizes the CFTC to adopt capital and margin requirements for swap dealers and MSPs that are not banks. CEA Section 4s(e)(2)(A) authorizes the Prudential Regulators to adopt capital and margin requirements for swap dealers and MSPs that are banks. Notably, the Dodd-Frank Act does not authorize the Prudential Regulators or the CFTC to adopt minimum margin requirements that apply to commercial end users. Congress's intent was unambiguous that neither the Prudential Regulators nor the CFTC should impose mandatory margin on end user swaps. Accordingly, the Joint Associations submit that the Prudential Regulators' proposed margin rule is inconsistent with Congress' intent and the plain language of the Dodd-Frank Act.

[19] CEA Section 4s(e)(3)(C) ("[i]n prescribing margin requirements . . . the Commission . . . shall permit the use of noncash collateral, as [it]. . . determines to be consistent with . . . (i) preserving the financial integrity of markets trading swaps; and (ii) preserving the stability of the United States financial system.").

[20] *See* 76 Fed. Reg. at 27,578.

The CFTC should continue to permit swap dealers and MSPs that transact with commercial end users to provide any form of non-cash collateral that is mutually agreeable to both parties. Although it may be difficult to establish accurate haircuts by regulation or to provide objective criteria for valuing non-cash collateral through a rule-based approach, the Dodd-Frank Act does not require the CFTC to perform this function, particularly with respect to transactions to which commercial end users are parties.[21]

C. *Swap documentation, collateral valuation, specific swap exposure calculations, and other credit risk management regulatory requirements are unnecessary for commercial end user transactions.*

CEA Section 4s(i) provides that "[e]ach registered swap dealer and [MSP] shall conform with such standards as may be prescribed by the Commission by rule or regulation that relate to timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps."[22] The Dodd-Frank Act does not require the CFTC to establish particular swap documentation, collateral valuation, specific swap exposure calculations, or other credit risk management requirements.[23] Nevertheless, the Proposed Margin Rule would require swap dealers and MSPs to enter into credit support arrangements that include specific collateral valuation provisions with *all* swap counterparties, including commercial end users, and would make compliance with the terms of these provisions a regulatory (in addition to contractual) obligation.[24] For example, swap dealers and MSPs would be required to include in their trading documentation specific "methods, procedures, rules, and inputs for determining the value of each swap."[25]

It is unnecessary for the CFTC to impose prescriptive documentation, collateral valuation, exposure calculations, or credit risk management requirements on swaps entered into by commercial end users. The terms of a bilaterally negotiated, non-cleared swap are mutually agreed upon by the parties and legally enforceable. There is no compelling public policy reason to impose additional documentation or compliance requirements that would serve only to convert a contractual breach into a separate regulatory violation.

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[21] *See also* 76 Fed. Reg. at 23,739. In addition, to the extent the CFTC impose valuation requirements on non-cash collateral, such valuation requirements should only apply to collateral posted over and above the credit threshold (if any) agreed to by the parties to the transaction.

[22] CEA Section 4s(i) (emphasis added).

[23] *See also* comments filed by EEI, NRECA, APPA, and LPPC on April 11, 2011 in response to the proposed Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants rule. 76 Fed. Reg. 6,715 (Feb. 8, 2011).

[24] In addition, the Proposed Rule would require swap dealers and MSPs to calculate exposure associated with *all* non-cleared swaps, including non-financial commodity swaps entered into by non-financial end users for the purpose of hedging or mitigating commercial risk, even though these calculations would be separate from (and in addition to) any credit analysis required under the parties' mutually negotiated trade documentation.

[25] 76 Fed. Reg. at 23,738.

The fact that some commercial end users may voluntarily agree to margin provisions in connection with a non-cleared swap with a swap dealer or MSP does not mean that the CFTC should *require* that specific documentation be in place for every transaction. As a practical matter, the way in which many of the Joint Associations' members routinely document and provide credit support for their risk management and other commercial transactions may not fit easily within the framework in the Proposed Margin Rule. Non-cleared swaps are bilaterally negotiated contracts, often with customized terms that are tailored to meet the parties' specific needs and circumstances surrounding the transaction. It is unnecessary and impractical for the CFTC to regulate the many ways in which commercial end users and their counterparties agree to value and manage their mutual risks.

The CFTC should not adopt prescriptive regulations that specify how each swap dealer, MSP, and indirectly, commercial end user must manage its credit risk.[26] Similarly, the CFTC should not prescribe any specific settlement or valuation cycle. Daily or even weekly margin calculations are impractical (and unnecessary) in many cases. Instead, a swap dealer or MSP and a commercial end user should be allowed to continue to agree to a variety of credit support arrangements and to accept non-cash collateral, even if it may be difficult to value on a regular basis, and to calculate exposure on an aggregated, portfolio basis (*i.e.*, by considering netted swap exposures, netted physical commodity exposures, loans extended and letters of credit participations) without violating any regulatory obligations. Engaging in commercial transactions with or without margin, based on reciprocal evaluation of each party's credit and proposed collateral is more efficient than imposing specific credit and collateral valuation requirements, particularly for swap dealers and MSPs transacting with commercial end users under well-established business practices that are tailored to their specific credit risk assessments. The Joint Associations respectfully submit that such an approach does not increase the risk posed to swap dealers or MSPs, the swaps markets, or the United States financial system as a whole.

In addition, the Joint Associations respectfully request that the CFTC to continue to permit commercial end users and their counterparties to agree to the two-way posting of collateral. Bilateral credit arrangements do not raise any concerns with respect to the safety and soundness of swap dealers or MSPs. On the contrary, bilaterally negotiated swaps that provide for two-way posting of collateral allow both parties to the transaction to manage their risks effectively and on equal terms. Permitting the parties to a non-cleared swap to enter into reasonable and mutually agreeable credit support arrangements is consistent with the statutory criteria that the Commission is directed to take into account under sections 731 and 764 of the Dodd-Frank Act and current commercial practice. Nothing in the Proposed Margin Rule prohibits credit support arrangements that provide for two-way margin, and the CFTC should not amend the Proposed Margin Rule to prohibit this beneficial practice.

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[26] For example, although a minimum transfer amount of $100,000 may be reasonable in many situations, higher amounts are justified in certain circumstances. 76 Fed. Reg. at 23,744. The Commission should not subject the details of every non-cleared swap to prescriptive requirements or unnecessary regulatory oversight.

V. Conclusion

We encourage the CFTC to ensure that commercial end users are not subject, directly or indirectly, to regulatory requirements that Congress intended to apply only to swap dealers and MSPs. Accordingly, we encourage the Commission to establish regulatory requirements that accurately reflect the risk associated with individual counterparties and transactions, and that preserve the benefit of the end user clearing exception by permitting commercial end users to continue to negotiate the terms of their swaps, including credit support arrangements, free from unnecessary restrictions on the amount, type, or terms of collateral that must be posted. Please contact us at the numbers listed below if you have any questions regarding our comments.

Respectfully submitted,

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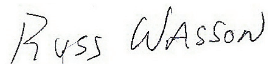

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