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5 Dodd-Frank Reforms That Keep Energy Attys Up At Night

By **Keith Goldberg**

Law360, New York (September 11, 2014, 2:13 PM ET) -- Energy companies rely on derivatives and other complex financial products to hedge against the risks of their inherently volatile businesses. But the Dodd-Frank Act is making those financial products subject to stricter regulations, thrusting energy firms into a brave new world of increased — and not necessarily welcome — compliance and the costs that accompany it.

“The energy companies have been saying, ‘We're not the AIGs or Lehman Brothers that are coming up with these complex derivatives, we're just the ones that use them to hedge risks in our business,” said Perkins Coie LLP partner Jason Kuzma. “It's been a culture change more than anything.”

Most of the Dodd-Frank rules affecting energy firms — primarily issued by the U.S. Commodity Futures Trading Commission — are already on the books either in proposed or final form.

“There are few important ones left, but we're really in the phase of implementation and compliance,” said Stephen Humenik, a former counsel to former CFTC Commissioner Scott O’Malia who now leads Covington & Burling LLP’s futures and derivatives practice. "For a global energy company, the biggest question is: How do you put in place a global compliance program that covers all bases?"

Here, attorneys share with Law360 five aspects of Dodd-Frank that are causing the most concern for energy firms and their counsel:

Position Limits

Attorneys say it’s the most burning Dodd-Frank issue for energy firms: the CFTC's revised proposal in November, which **sets limits on speculative positions** in 28 physical commodity futures as well as swaps that are "economically equivalent" to those contracts.

“One positive sign from the CFTC is that the comment period was reopened twice,” Humenik said. “That being said, there is a lot of criticism over the proposed rule. It doesn't adequately address how energy firms manage the risk of their commercial operations."

The proposal calls for strict limits on the types of hedging transactions that would be exempt from the position limits — known as bona fide hedging exemptions — which could make it harder and more expensive for energy companies to guard against price swings, attorneys say.

“What people do today doesn't appear to match what the commission has proposed,” said David Perlman, a Bracewell & Giuliani LLP partner.

That includes strategies such as dynamic hedging as well as hedging across an entire energy portfolio.

“You can’t necessarily match each megawatt to each piece of steel in the ground,” Baker Botts LLP partner Elaine Walsh said. “It’s looking across someone’s entire generation fleet or electrical load;

you can't just evaluate at some static point in time."

Trade Options

Energy companies frequently enter into contracts such as the future delivery of electricity that contain so-called trade options — for example, an electricity buyer having the option to buy additional megawatts at a certain point in time.

These option-laden contracts initially fell under the CFTC regulation under Dodd-Frank, but when the commission issued its final swap definition in 2012, it included a seven-part test that energy firms could use to determine whether those contracts qualified as swaps and were subject to Dodd-Frank regulation. A contract that satisfied all seven parts would qualify as a physical forward contract and be exempt from Dodd-Frank swaps regulation.

But attorneys say the seventh prong of the test — which says that the options in contracts must be based on factors outside the parties' control, such as physical or regulatory requirements — is murky and could sweep contracts containing options like the ability to purchase power if it's cheaper into swaps territory and stricter regulation.

"The definition of the seven-prong test still creates uncertainty over many different types of what would otherwise be considered straightforward physical contracts," said Michael Sweeney, a Sutherland Asbill & Brennan LLP partner.

What's more, despite their physical, nonfinancial nature, trade options are included in the CFTC's position limits, creating an additional, unnecessary restraint on the hedging deals available to energy firms, attorneys say.

"The inclusion of those trade options within position limits is really viewed as not within the intent of Dodd-Frank," Winston & Strawn LLP partner Michael O'Brien said. "These are not speculative transactions, they are transactions that would physically settle."

The CFTC's Swap Definition

The uncertainty over the seventh prong of the CFTC's seven-part swap test underscores a central issue for energy companies: The commission's definition of a swap is still unclear, even as it has unveiled swaps regulations mandated by Dodd-Frank, attorneys say.

"These swaps regulations haven't been applied to commodities yet," Kuzma said.

That's a fundamental regulatory uncertainty for energy firms, because they don't know which trades they have to publicly report, according to Reed Smith LLP partner Patty Dondanville.

"How do you know you have to keep records of something if you don't know whether it's a swap?" Dondanville said. "That fundamental question underlies most of the implementation problems that have bedeviled end users since they began implementing the rules."

Capital Rules for Swap Dealers

Energy firms breathed a sigh of relief last week when federal banking regulators proposed a Dodd-Frank-mandated **margin and capital requirements rule** for swap dealers conducting swaps outside of clearinghouses because it won't require them to post margin for their uncleared swaps.

"It's a form of credit support that typically isn't done by your average energy company — it's done by trading companies," Dondanville said.

It's also essentially in line within the margin rules proposed by the CFTC in 2011. But the commission has yet to propose its own capital requirements for swap dealers that sidestep clearinghouses, and energy firms worry that they would ultimately foot the bill for stiffer capital requirements for the dealers they work with, attorneys say.

“The size of energy transaction swaps that are not cleared are significant, because their hedges are significant,” Dondanville said. “If the swap dealer has to set aside regulated capital to reflect that not-cleared swap, the bank is going to pass through the cost to the counterparty, meaning the energy company."

Project finance is one area that could get more expensive, according to Walsh. Companies usually give liens to underwrite swaps used in financing power plant development, she said.

Capital requirements for swap deals “will go into the prices that are paid for those secured swaps, and it’s going to affect liquidity,” Walsh said. “How many people are going to be out there offering those types of terms, or cash, and other forms of liquid security? Even some of the very big power producers — they don’t have the investment-grade guarantees to back them up.”

The CFTC’s Financial Entity Definition

In mandating tighter financial regulations, Dodd-Frank included a definition of a financial entity. But attorneys say it’s unclear whether energy companies are covered by that definition, and firms worry that their hedging activities could sweep them into a regulatory regime that mainly targets banks and other financial institutions.

“There's no definition of financial entity by the CFTC,” Perlman said. “An electricity company that's got 15 power plants that sell all their output to a market-facing affiliate that does hedging — that stand-alone marketing company could be viewed as a financial entity, even though it's not a bank or hedge fund.”

Many energy companies have a central trading desk, which does the hedging on behalf of the entire company, according to Sweeney.

“The way the term ‘financial entity’ is defined under Dodd-Frank, the definition cross-references banking law and will pull them into a much stricter regulatory regime and impose more financial institution-like requirements on energy companies that have trading desks,” Sweeney said. “They may not be able to use the end user exemption for swaps and be subject to stricter prudential requirements.”

--Editing by Jeremy Barker and Philip Shea.