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Attorney-Client Work Product
Reed Smith Draft 5/2/12-
Approved by Petitioners for Submission to CFTC
For Discussion Purposes

PETITION FOR CLARIFICATION OF, OR EXCLUSION FROM, APPLICATION OF THE "SPECIAL ENTITY SUB-THRESHOLD" IN THE DE MINIMIS EXCEPTION TO THE "SWAP DEALER" DEFINITION FOR "UTILITY OPERATIONS-RELATED SWAPS" TO WHICH "UTILITY SPECIAL ENTITIES" ARE A PARTY

I. **Summary**: Petition for an order clarifying, or granting an exclusion from, application of the $25 Million "Special Entities Sub-Threshold" in the de minimis exception to the CFTC's definition of "Swap Dealer" for "Utility Operations-Related Swaps" entered into by "Utility Special Entities." The Utility Operations-Related Swaps would remain subject to the overall $3 Billion De Minimis Threshold applicable to swap dealing activities (and to the $8 Billion De Minimis Threshold applicable during the Phase-In Period).

II. **Petitioners**: The Petition is filed by the American Public Power Association (APPA), the Large Public Power Council (LPPC), the Transmission Access Policy Study Group (TAPS), the Bonneville Power Administration (BPA) and the American Public Gas Association (APGA), seeking clarification or the exclusion on behalf of all existing and future Utility Special Entities.[1]

III. **Reason for the Petition**. If the Commission declines this Petition, we have been informed that many of the nonfinancial entities on which Utility Special Entities rely to act as available counterparties to the Utility Special Entities' commercial hedging activities in customized Utility Operations-Related Swaps will cease to participate in any meaningful way in such swaps with Utility Special Entities. As a direct consequence, Utility Special Entities' costs to hedge commercial risks arising from utility operations will increase, and those costs will be passed on to utility customers.

A. A "Utility Special Entity" means a government "Special Entity" (as described in clause (i) and (ii) of Section 4s(h)(2)(C) of the CEA, and as the

[1] See comments filed by NFP Electric End User Coalition, including APPA and LPPC and supported by TAPS, in the Commission's "Entity Definitions" docket, a link to which appears at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27917&SearchText=rural at 18-19, supporting the request for a significantly higher threshold than was proposed by the Commission for ***both*** the general De Minimis Threshold and the Special Entity Sub-Threshold in the comments filed by the Edison Electric Institute in the same docket, a link to which appears at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27918&SearchText=.

term “Special Entity” may be further defined in the CFTC’s rules) that owns or operates electric or natural gas facilities, or electric or natural gas operations (or anticipated facilities or operations), supplies natural gas to other Utility Special Entities, or has public service obligations (or anticipated public service obligations) under Federal, State or local law or regulation to deliver electric energy and/or natural gas service to customers.

B. All such entities are tax exempt government entities, with a shared public service mission and conservative and experienced management of utility operations. Such entities transact in such “swaps”[2] as “end users”[3] to hedge or mitigate commercial risks,[4] and not to speculate, trade for profit, or act as dealers in respect of such swaps.

C. Utility Special Entities have need for highly customized Utility Operations-Related Swaps to match the unique operational/commercial risks that each Utility Special Entity is seeking to hedge. Such entities need long term price certainty (for utility customers) and long term certainty of supply to specific geographic areas during specific forecasted seasonal peaking needs for energy and other commodities used in utility operations (for utility planning and service reliability purposes). Utility Special Entities are offered swaps in this asset class and of these product types and categories, and Utility Special Entities execute such swaps with, not only Wall Street firms and other financial entity “swap dealers” active in these and other swap asset classes, product types and categories, but with nonfinancial market participants with experience in these swap product types, but that may not generally “deal” in other swap asset classes and, in

[2] When we use this term, we use it in the traditional sense of a financial derivative – an agreement, contract or transaction that by its terms calls for financial settlement with the financial settlement based on a change in value of an underlying reference commodity, asset, event or occurrence.

[3] This term is not defined in the Dodd-Frank Act. Congress also refers to these entities as “commercial end users,” but that term is not defined in the Dodd-Frank Act either. In the Dodd-Frank Act legislative history, Congress used the term “commercial end user” or, in shorthand “end user,” to mean an entity that has the right to elect the “end user exception” provided in new CEA Section 2(h)(7). That Section provides that the “end user exception” cannot be elected by a “financial entity” as therein defined. The Utility Special Entities are all nonfinancial entities and the Petitioners anticipate that Utility Special Entities will use the end-user exception in respect of a significant number of the “swaps” to which they are parties.

[4] This phrase is used in the Petition as defined in CEA Section 2(h)(7)(A)(ii).

some cases, that may not "deal" in the same swap product types delivered to other geographic areas of the country.[5]

D. Nonfinancial non-"swap dealers" act as important counterparties for Utility Special Entities. Because of the highly illiquid nature of the "markets" for these types of swaps, it is important that Utility Special Entities have a choice of counterparties (so that there is competition for their customized swap transactions).[6] The price volatility in the markets for such commodities and swaps, the sizeable notional value of even the smallest volume or quantity of the underlying commodity, and the long term nature of the commercial risks that Utility Special Entities seek to hedge make the markets for these swaps unique.

E. Today, a large number of Utility Operations-Related Swaps to which Utility Special Entities are parties are executed with nonfinancial entities engaged in the electric and natural gas industry in the same geographic area as the Utility Special Entity. Wall Street financial institutions and other financial entity swap dealers tend to offer such swaps only where there is standardization and liquid trading markets: at trading hubs where the swap dealers' swaps can be hedged to maintain a "balanced book." Because the Utility Special Entity is hedging a commercial risk, its focus is to align the swap as closely as possible with the underlying and unique commercial risk being hedged, rather than settle for a more standardized, short-term, and therefore imperfect hedge for such commercial risk.

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[5] Utility Special Entities may also be called upon from time to time by other utilities located in the same geographic region, by or in coordination with electric reliability organizations, to act as counterparties in Utility Operations-Related Swaps for electric system reliability purposes. Such swaps should not be considered as swap dealing activity by the Utility Special Entity, and should not be considered swap dealing activity by the utility counterparty or counterparties to such swaps. Otherwise, the Utility Special Entities may not be able to participate in such swaps for reliability purposes, which may compromise the reliability of the interconnected electric system.

[6] An unintended consequence of the $25 million Special Entity Sub-Threshold applied to Utility Operations-Related Swaps would be to limit available counterparties and force Special Entities to engage in Utility Operations-Related Swaps with financial institutions and other entities that are planning to register with the CFTC as "swap dealers." This would concentrate, not disperse, risk to the United States financial system. Such Utility Operations-Related Swaps with financial institution "swap dealer" counterparties may also require the posting of cash margin by Utility Special Entities (depending on the prudential regulators' final rules on capital and margin), and may or may not be an activity in which such financial institutions or "banking entity" affiliates are permitted to engage once the Volcker Act and other provisions of the Dodd-Frank Act rulemakings are finalized.

F. We have been informed that many of the nonfinancial entities that engage in these types of customized swaps with Utility Special Entities do not intend to register as regulated "swap dealers." Consequently, once the new Dodd-Frank Act rules are effective and as compliance dates approach, these entities will restrict their swap dealing activity to stay well below the de minimis exception thresholds in the CFTC's swap dealer definition.[7]

G. The $25 million aggregate gross notional amount "Special Entities Sub-Threshold" puts an unworkable and inappropriately low ceiling on any such nonfinancial entity's ability to transact with Utility Special Entities without being considered a "swap dealer," in the very product types of swaps that the Utility Special Entities need to hedge their unique commercial risks. A single one-year 100 MW swap or a single three-year 10,000 mmBtu/day swap (at a 62% capacity factor) may have a notional value of $25 million.[8] A nonfinancial entity would, therefore, enter into only ***one such swap*** with Utility Special Entity counterparties in any rolling twelve-month period. Utility Special Entities could still look to registered swap dealers for these types of swaps, or could use less customized, more expensive commercial risk management solutions. The nonfinancial non-"swap dealer" counterparties could still enter into up to $3 Billion notional in swaps, or even $3 Billion in Utility Operations-Related Swaps, with counterparties other than Utility Special Entities. But Utility Special Entities would be denied access to such commercial risk management tools from these otherwise active participants in these illiquid markets for no regulatory benefit.

[7] We have discussed the Special Entity Sub-Threshold with energy trade associations and with large nonfinancial entities that regularly act as counterparties to Utility Special Entities in these types of swaps. A number of these entities have indicated to Petitioners that they share our concerns, and that they are prepared to file comments in support of this Petition.

[8] These examples are based on available quotes for 100 MWs of 7x24 electric energy for calendar year 2013 at Mid-C, PJM West and SP-15 for "Firm LD" power, and on Henry Hub calendar strip prices for natural gas. Each of these examples is for a relatively liquid delivery point, and for swaps that are not customized as are many Utility Operations-Related Swaps. To put these examples (and the $25 million Sub-Threshold) in context, the Los Angeles Department of Water and Power owns or operates 6000 MWs of electric generation, and the New York Power Authority owns or operates 7400 MWs of electric generation. JEA, formerly the Jacksonville Electric Authority, hedges approximately 13.8 million mmBtus of natural gas in an average year as part of its fuel procurement process for electric operations, based on the past 5 years actual hedging activity. If each of these Utility Special Entities was limited to one $25 million hedge per year with each non-"swap dealer" counterparty, it would dramatically limit the ability of these Utility Special Entities to hedge or mitigate commercial risks arising from everyday utility operations.

H. For purposes of the Petition, the term "Utility Operations-Related Swap" means any "swap" that a Utility Special Entity enters into "to hedge or mitigate commercial risks" (as such phrase is used in CEA Section 2(h)(7)(A)(ii)) intrinsically related to the electric or natural gas facilities it owns or operates, or to the electric or natural gas operations (or anticipated facilities or operations) of the Utility Special Entity, or intrinsically related to the Utility Special Entity's supply of natural gas to other Utility Special Entities or its public service obligation to deliver electric energy or natural gas service to customers. For the avoidance of doubt, "intrinsically related" shall include all transactions related to (i) the generation or production, purchase or sale, and transmission or transportation of electric energy or natural gas, or the supply of natural gas to other Utility Special Entities, or delivery of electric energy or natural gas service to the Utility Special Entity's customers, (ii) all fuel supply for the Utility Special Entity's electric facilities or operations, (iii) compliance with electric system reliability obligations applicable to the Utility Special Entity, its electric facilities or operations, (iv) compliance with energy, energy efficiency, conservation or renewable energy or environmental statutes, regulations or government orders applicable to the Utility Special Entity, its facilities or operations, or (v) any other electric or natural gas utility operations-related swap to which the Utility Special Entity is a party. Utility Operations-Related Swaps shall ***not*** include a swap based or derived on, or referencing commodities in the interest rates, credit equity or currency asset classes of swaps, or of a product type or category in the "Other Commodity" asset class of swaps that is based or derived on, or referencing, metals, or agricultural commodities or crude oil or gasoline commodities of any grade not used as fuel for electric generation.

I. The exclusion is narrowly tailored to maintain the ability of the Utility Special Entity to hedge commercial risks inherent in its operations, without changing the general De Minimis Threshold for swap dealing activity (which would apply to Utility Operations-Related Swaps to which Utility Special Entities are party), and without changing the Special Entity Sub-Threshold for swaps involving Utility Special Entities in other asset classes or product types.

J. Nothing in the Dodd-Frank Act requires the Commission to establish a Special Entity Sub-Threshold in the de minimis exception to the "swap dealer" definition. We are not requesting that the Special Entity Sub-Threshold be eliminated, but that it apply only to asset classes of financial swaps, and to product types of "Other Commodity" swaps other than Utility Operations-Related Swaps. In defining the term "Special Entity" in the Dodd-Frank Act, Congress did not intend to restrict access to the narrow

category of swaps that Utility Special Entities need to cost-effectively hedge or mitigate the commercial risks of their operations.

IV. **Process and Timeline for the Petition.** A Commission response is requested as soon as possible to remove continuing regulatory uncertainty for the Utility Special Entities and their nonfinancial counterparties for Utility Operations-Related Transactions. The Petitioners are concerned about Utility Special Entities' ongoing ability to provide affordable, reliable utility service to their customers, as nonfinancial counterparties begin to turn away from transacting with Utility Special Entities in these important, but customized Utility Operations-Related Swaps, to focus on swaps with other counterparties.

A. We specifically request that the Commission post the Petition, and the Commission's proposed response, on the Commission's website in an easily accessible place prior to May _, 2012, without waiting for the final rule containing the "Special Entity Sub-Threshold" to be published in the Federal Register. Moreover, in order to respond to the energy industry's concern and to avoid immediate request(s) for reconsideration or other legal challenges to the final rules, we request that the Commission promptly inform Petitioners and the public of the administrative procedure for resolving the Petition. We recommend a public comment period of no longer than 20 days after posting on the Commission's website, and publication of the Commission's final response within 10 days thereafter.

B. The Petition requests that the Commission's response be retroactive to the enactment date of the Dodd-Frank Act, and prospective for all Utility Operations-Related Swaps to which a Utility Special Entity is a party.

C. There is no need to wait for the final rules further defining "swap," as the clarification or exclusion will only be applicable to those utility operations-related transactions which would be included as "swaps," and would therefore be considered "swap dealing activity" and counted toward the Special Entity Sub-Threshold and the De Minimis Threshold.