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Living with Uncertainty: Energy Companies and Dodd-Frank

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Mention Dodd-Frank (the Wall Street Reform and Consumer Protection Act) and most people immediately think of the 2008 financial crisis and banks. This is probably because most journalists and analysts comment mostly on Dodd-Frank's possible impact on banks. Yet, numerous other sectors of the economy have to adjust to Dodd-Frank's requirements, particularly in the area of financial and commodities derivatives.

The following is the first in a series discussing the evolving impact of Dodd-Frank on all sectors. In this article, we'll focus on energy companies and Dodd-Frank's requirements on derivatives.

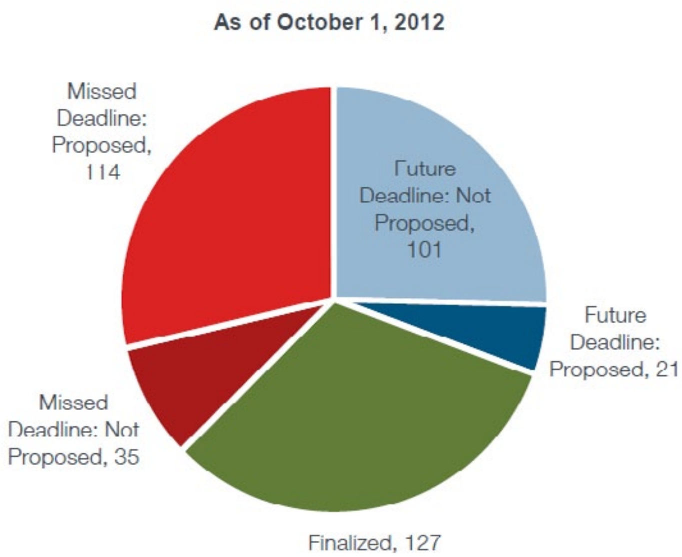
The origins of Dodd-Frank's requirements on financial and commodity derivatives lie in the 2009 G-20's Pittsburgh communiqué. Due to the 2008 financial crisis, G-20 countries set forth four core tenets for over-the-counter derivatives reform:

- All "vanilla," over-the-counter contracts should be traded on exchanges;
- Such contracts should be traded through central counterparties (CCPs);
- Such contracts should be reported to trade repositories; and
- OTC contracts that are not cleared by a CCP should be subject to higher capital requirements.

October 12 is supposed to be the start date for numerous derivatives rules. Yet, the U.S. Commodity Futures Trading Commission has been coping with an avalanche of competing requests from banking and non-financial corporate lobbying groups either to ease or at least to delay the Wall Street Reform and Consumer Protection Act measures.

No matter how many delays might happen, Dodd-Frank is here to stay. Irrespective of who wins the U.S. election November 6, it would be practically impossible to rescind Dodd-Frank, especially since some components are agreed upon by both political parties, many components are quite popular with Main Street, and many banks and companies have been making significant changes to prepare for the requirements

Not all Dodd-Frank rules have been written yet, so part of the greatest challenge for energy companies is living in a world of uncertainty. If anyone can manage, it is indeed commodities and energy companies, because the very nature of these sectors involves living with the unpredictability that arises from country, economic, and operational risks, that is, the breach in the day to day running of a business due to people, processes, technology and external threats.



Source: Davis, Polk, October 2012

WHO IS IN CHARGE?

Under Dodd-Frank, the Securities and Exchange Commission and the CFTC are now responsible for regulating over-the-counter derivatives. The SEC is responsible for securities-based swaps such as single-name credit default or equity swaps. Whereas the CFTC is responsible for non-securities based swaps. Importantly, for energy derivatives trading, the CFTC is responsible for:

- Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties;
- Large Trader Reporting for Physical Commodity Swaps;
- Position Limits for Futures and Swaps;
- Real-Time Public Reporting of Swap Transaction Data;
- Swap Data Recordkeeping and Reporting Requirements;
- Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants; and
- Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps.

WHAT RELEVANT RULES ARE FINAL AND WHAT KEY RULES REMAIN OUTSTANDING?

This August, the "swap" was formally defined to include options and basis arrangements, as well as swaps based on commodities, energy, emissions and weather. Importantly, the definition excludes "forward contracts" in physical commodities, so long as such contracts are intended to be physically settled at the time of execution.

The CFTC also finalized the definition of "swap dealer." Unfortunately, there is no clear test for what constitutes swap dealing, which, among other things, includes engaging in swaps to accommodate the needs of others, as opposed to one's own particular trading purposes. However, there are de minimis thresholds of $8 billion (transitioning to $3 billion in approximately three to five years) in aggregate gross notional amount of swaps (across affiliates) in any 12-month period, or $25 million for dealing activities with respect to "special entity" counterparties such as governmental bodies, pension plans and endowments.

Companies that transact swaps and that believe they are not swap dealers should document their analysis to that effect very carefully and seek the advice of lawyers with financial regulatory specialty, so that they can respond to potential inquiries by counterparties or the CFTC.

In mid-September, the Commodity Markets Council petitioned the CFTC to postpone the October 12 start date for tallying swaps trades towards the key "dealer" threshold. The council's main points were that members need more clarity on the rules and time to build up their compliance. At present, it looks like the delay will be granted. Specifically, energy companies have to establish a compliance process, regulatory reporting procedures, and making sure that companies have the necessary skill set. For energy companies, the biggest challenge will be juggling how to live in an environment of uncertainty and possible increases in costs.

In an important win for energy and commodities companies, along with banks trading commodities

derivatives, Washington U.S. District Judge Robert Wilkins ruled on September 27 the 2010 Dodd-Frank Act required more study before setting caps on positions in oil, natural gas, wheat and other commodities. According to the ruling, the CFTC failed to assess if the rule was necessary and appropriate under the law. The CFTC had estimated the limits could affect 85 energy trading firms, 12 metals traders and 84 traders of certain agricultural contracts. The fact that position limits were struck down means that the CFTC will either appeal the decision or will have to rewrite those rules, either of which will take a long time and delay the final position limit rules for energy companies.

Recently, energy trade groups Edison Electric Institute (EEI), the American Gas Association (AGA), and the Electric Power Supply Association (EPSA) released a joint statement stating that some CFTC draft rules rulemakings "are still in a state of flux, pending the resolution of the Commission's requests for further comments." The final rule for Swap Execution Facilities (SEFs) for example, is still pending as of the end of publishing of this piece.

Due to the fact that Dodd-Frank focuses substantially on regulating OTC derivatives and having them become more transparent, companies involved in energy derivatives trading will be impacted just as much if not more so in some ways than banks. Whether they like it or not, banks are used to being regulated in a way that requires them to focus on data, models, and regulatory reports. In essence, Dodd-Frank will influence energy companies to rethink their risk management, that is, the identification, measurement, control, and monitoring of their credit, market, operational, liquidity, and legal risks.

Areas Affected	Potential Implications
Energy derivatives	Strategy/business model; risk management
Business entity categorization: exempt vs. non-exempt	Strategy/business model; regulatory requirements reporting, process and controls; liquidity
Clearing and trading	Liquidity; risk management
Counterparty status	Liquidity; risk management
Non-cleared swaps reporting	Regulatory requirements, reporting, process and controls
Energy trading process and procedure development	Regulatory requirements reporting, process and controls;
Energy trading disclosure requirements	Regulatory requirements reporting, process and controls;
Government payment disclosure requirements	Regulatory requirements reporting, process and controls;
Trading exchange requirements, controls, and reporting	Regulatory requirements reporting, process and controls;
Trading activity controls	Regulatory requirements reporting, process and controls;
Trading tax liabilities	Liquidity

DATA COLLECTION

The first step for energy companies will be finding the necessary data. Sometimes indentifying who knows where all the data is can be a challenge. Is it all in one group or several groups, maybe even across different legal entities or across borders collecting the same information? It is not unusual to have these inefficiencies, especially if companies have undergone mergers. Another, potential significant operational challenge is having people not wanting to share data with other members of the same organization. Silo mentalities certainly make it difficult to create a centralized trading risk management system.

DATA REPORTING

Secondly, energy companies will have to make significant adjustments in order to meet the necessary reporting requirements. After a derivatives trade is agreed upon, traders are done, but there is much more to the life cycle of commodities derivatives. This April, ISDA approved a proposal from Depository Trust and Clearing Corporation (DTCC) and EFETnet to establish a commodity trading repository. Global commodity derivatives trading entities can use this repository not just to fulfill Dodd-Frank requirements but also those of some European and Asian regulations.

The CFTC has approved two databases, DTCC Data Repository LLC and ICE Trade Vault LLC, to collect information on interest- rate, credit, energy and other swaps to improve access for the public and regulators. According to CFTC Chairman Gary Gensler, there are about four additional applicants who want to become swap data repositories. Reportedly, CME Group and IntercontinentalExchange, Inc., would also like to be global commodities repositories.

The area of risk management where a lot of changes will take place is in monitoring. The kind and quality of companies' trading and risk management systems will be critical. Energy companies must evaluate whether their systems have the sufficient capacity to accommodate the significant new volumes of data that will be required for Dodd-Frank regulatory reporting purposes. If there need to be changes to the systems, then risk managers will have to evaluate whether different personnel is needed or whether existing personnel needs to have their skills upgraded.

Moreover, management will need to verify if existing internal auditors, compliance officers and back office personnel need training in understanding new system changes. Above all, energy company risk management will need to be aware constantly of how Dodd-Frank rule writing continues to evolve in order to identify any further challenges that will have to be measured, controlled, and monitored.

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