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Dodd-Frank's Eye On Energy Cos.' Use Of Derivatives

Law360, New York (April 7, 2011) -- President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law almost nine months ago, but because of the amount of implementation left to regulators, the ultimate form of the law remains to a significant extent unknown.

In recent months, those regulatory agencies have begun to issue rules and regulations at a fast and furious pace. From those rulemakings, it is increasingly clear that the law will significantly affect how energy companies use derivatives in their daily business. Still, many uncertainties and questions remain about how dramatic the changes — and the resulting costs — will be.

Clearing and Margin

One of the primary goals of Dodd-Frank is to move most of the over-the-counter (OTC) derivatives market onto regulated clearing exchanges. Backers of the legislation believe that such a move will increase transparency and spread the risks of default among market participants.

As a counterbalance, however, energy companies will be required to post liquid margin — i.e., cash or Treasury Notes — to collateralize their positions. Although energy companies are accustomed to posting collateral in their OTC transactions, the margin required by clearinghouses — including initial margin that is independent of market movements, and variation margin that changes based on daily market fluctuations — may be considerably greater.

In much of the OTC market, many participants are given some unsecured credit exposure (or credit thresholds) based on their creditworthiness. Companies will not have such thresholds with the exchanges.

This clearing requirement will alter the way in which many energy companies hedge their positions. As one example, before Dodd-Frank, producers may have entered into a hedge with the purchaser of their physical commodities. Any market movement would result in opposing movements in exposure under the physical and financial contracts — efficiently locking in a profit or loss while providing credit security based on the offsetting exposure changes.

Under Dodd-Frank, however, the hedge could not function as efficiently, because the producer's counterparty would not be the same entity under the physical and financial transactions. As a result, the producer and counterparty would lose their ability to exercise exposure netting.

Recordkeeping and Reporting

It appears likely that the new regulations will impose relatively burdensome obligations on energy companies in the context of recordkeeping and real-time reporting. The Commodity Futures Trading Commissions has issued a proposal that would require all swap market participants to keep full, complete and systematic records regarding each swap.

Under the proposed rulemaking, "all pertinent data and memoranda" must be retained — although the CFTC has not yet provided conclusive guidance on the scope of that phrase or the period of time that such records must be retained.

The requirement will likely cause concern to many market participants. Existing systems may be inadequate for smaller players to meet the necessary recordkeeping requirements. In time, those players can develop the systems to allow them to comply, but only with potentially considerable expenditure of time and money.

To be sure, there is some degree of public good accomplished from the retention and sharing of such information with regulators. But how that result balances against the costs imposed by the requirement is an open question.

The CFTC also proposes to extend real-time reporting requirements to all swap market participants. If the proposed rule is adopted, participants will be required to share price and volume data "as soon as technologically practicable." Swap dealers and other larger parties will be more likely to be able to implement the technology and systems necessary to comply with such requirements, though presumably at significant additional costs.

On the other hand, many end-users — which are more likely to use off-the-shelf software to capture trading data — will not. The costs for them to develop compliant systems would likely be substantial, and potentially disproportionate.

Position Limits

Position limits represent another potentially burdensome area of Dodd-Frank. The law requires the CFTC to establish position limits for commodities-related futures, options contracts and swaps that are the economic equivalent to such contracts.

In response, the CFTC has issued a notice of proposed rulemaking that would impose position limits on transactions involving metals, energy commodities and agricultural commodities. The proposal is subject to exemptions for bona fide hedging and positions established in good faith prior to the effective date.

Historically, individual exchanges imposed some position limits and accountability levels for certain commodity futures and options. Until now, however, the CFTC played no such role and swaps have not had any such restrictions at all. Many are concerned that, with relatively little data on the OTC markets and little prior experience in setting such limits, the CFTC will have little guidance on the appropriate limits.

Treatment of Collateral

More uncertainty surrounds the treatment of collateral under Dodd-Frank. The CFTC has proposed that the initial margin for cleared swaps will be established by clearinghouses, with some regulatory guidance. If there is a default by another customer of the clearing member, is there a risk that posted margin could be used to absorb the loss? At present, the answer is unknown — but that appears to be a possibility.

Another unanswered question is whether additional margin could be required by clearing members, in addition to the amount required by the clearinghouse. For a variety of reasons, it appears that the margining requirements will be significantly greater than they have been in OTC markets. Moreover, in OTC transactions, parties could agree to receive noncash forms of collateral. It remains unclear whether those additional forms of margining will be permitted by the CFTC and the clearinghouses.

The Orderly Liquidation Authority

A separate title of the Dodd-Frank legislation creates the Orderly Liquidation Authority (OLA). The purpose of the OLA is to address the perceived problem of "too big to fail" entities that are financial or quasi-financial in nature. In response, the law allows the Federal Deposit Insurance Corporation and the U.S. Department of Treasury to liquidate systematically important nonbank "financial companies" that are in danger of default.

Although the legislation seeks to prevent bailouts like that of American International Group Inc., it is conceivable that an energy company with a reasonably large derivatives trading book could qualify for treatment under the OLA.

Under the OLA, if the FDIC and Treasury determine that a financial company is in default or in danger of default, it may become subject to a receivership, with the FDIC as receiver. The OLA provides a framework for the FDIC to liquidate that company in a manner that aims to prevent contagion in the financial markets. The liquidation scheme is very similar to that in the Bankruptcy Code (and even more similar to that of the Federal Deposit Insurance Act), but a handful of variations could be very meaningful.

For example, the OLA restricts the enforceability of one-way termination provisions in swaps, forward contracts and other types of financial agreements. In addition, the OLA places limitations on other termination and setoff rights that the nondefaulting party would ordinarily retain in bankruptcy.

Overall, the differences between the OLA and the Bankruptcy Code are not great in number, but they could be significant in effect. It will be difficult for energy companies to fashion a risk-management strategy to respond to those differences, because it is impossible to know in advance whether a given counterparty may be subjected to the OLA.

Regulation of Commodity Options

The CFTC recently issued a proposed rulemaking stating that commodity options (including options on physical commodities) "clearly fall within the Dodd-Frank Act definition of swap." As a result, the CFTC proposes to revise its regulations to subject commodity option transactions in interstate commerce to the provisions of the Commodity Exchange Act.

Treating physical options as swaps may increase the compliance burdens on energy companies and harm markets where use of options in physical trading is common. Energy companies use options for a variety of purposes, and some — such as the use of options in asset management arrangements — may be far removed from the swap markets.

Nevertheless, it appears possible that Dodd-Frank may subject such transactions to the law's requirements on registration, clearing and margining. Moreover, the effect of the proposed rulemaking would likely force options to be treated on designated contract markets, unless the parties qualify as eligible contract participants.

The granular details of Dodd-Frank remain unknown to some extent, but the big picture is increasingly clear — and it is not especially positive for energy companies. Numerous energy companies will likely face significant increases in regulations and costs, or will need to change the way they do business and in their hedging strategies.

Potentially, the most disproportionate burdens will fall upon the smaller market players. For that reason, many market participants have been fighting for broader exemptions by filing comments with the CFTC and other regulators. Even if smaller players succeed in gaining exemptions from the direct costs, however, larger entities will likely pass along their higher costs to end-users.

Ultimately, Dodd-Frank will likely impose significant expenses throughout the energy industry. The nature of those expenses will be both direct and indirect, and among the indirect costs will be the loss of some mechanisms that previously provided energy companies with the ability to hedge their positions through derivatives contracts in a way that worked with their business strategies.

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