

**Meeting between Federal Reserve Board Staff and
Representatives of Edison Electric Institute
January 8, 2013**

Participants: Laurie Schaffer, Paige Pidano, Christine Graham, and Felton Booker
(Federal Reserve Board)

Lopa Parikh and Aaron Trent (Edison Electric Institute); David Arthur and Paul Breme (PPL); Brian Duncan (NextEra Energy Power Marketing, LLC); Lael Campbell (Exelon); and David Perlman (Bracewell & Giuliani)

Summary: Staff of the Federal Reserve Board met with representatives of the Edison Electric Institute, which is an association of shareholder-owned electric companies, to discuss the Board's proposed rulemaking to define "predominantly engaged in financial activities" for purposes of Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

Edison Electric Institute members expressed the view that, were the Board to finalize the proposed definition of "predominantly engaged in financial activities" set forth in the Board's supplemental notice of proposed rulemaking, some electric utilities may be considered to be "predominantly engaged in financial activities" due to the volume of their physically-settled derivatives activities.

In this event, Edison Electric Institute members were concerned that the Commodities Futures Trading Commission (CFTC) would treat these companies as "financial entities" under Title VII of the Dodd-Frank Act, which includes "a person that is predominantly engaged in...activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956."¹ Under Title VII, "financial entities" do not qualify for, among other things, the end-user exemption under the mandatory derivatives clearing provisions (Commodity Exchange Act section 2(h)(7) and 17 Part 39), are subject to higher margin and capital rules under the proposed margin regulations (proposed 17 CFR Part 23 and 12 CFR Part 237), and are not eligible for the CFTC's no-action relief for utility commodity swaps with special entities.

Edison Electric Institute members also provided the attached materials.

¹ See section 723 of the Dodd-Frank Act.



Edison Electric Institute

Power by AssociationSM

Definition of Financial Entity - Implications for the Energy Industry

Edison Electric Institute Member Meeting with
Board of Governors of the Federal Reserve System
January 8, 2012





Proposed Rule and Implications for EEI Members

Financial Entity under Title VII

- CEA 2(h)(7)(C) (as added by DFA 723) defines *financial entity* to include “a person predominantly engaged in activities that are ... financial in nature, as defined in section 4(k) of the Bank Holding Company Act” (“BHCA”).
- “Predominantly engaged” means those transactions represent 85% of an entity’s revenues or assets.

Current Status of Financial in Nature

The Federal Reserve lists most *financial in nature* activities in various places in Regulation Y:

- Currently activities that are “financial in nature” do not include derivative transactions or forwards for physical commodities unless those transactions are required to be cash settled.
- This would not include spot transactions, forwards or physical commodity derivatives (e.g. options) that are physically settled.
- The Federal Reserve has permitted banks to engage in transactions with settlement by *instantaneous, pass-through* delivery of title to the physical commodity (“transitory title”)
- This arguably happens in many transaction that physical energy companies engage in

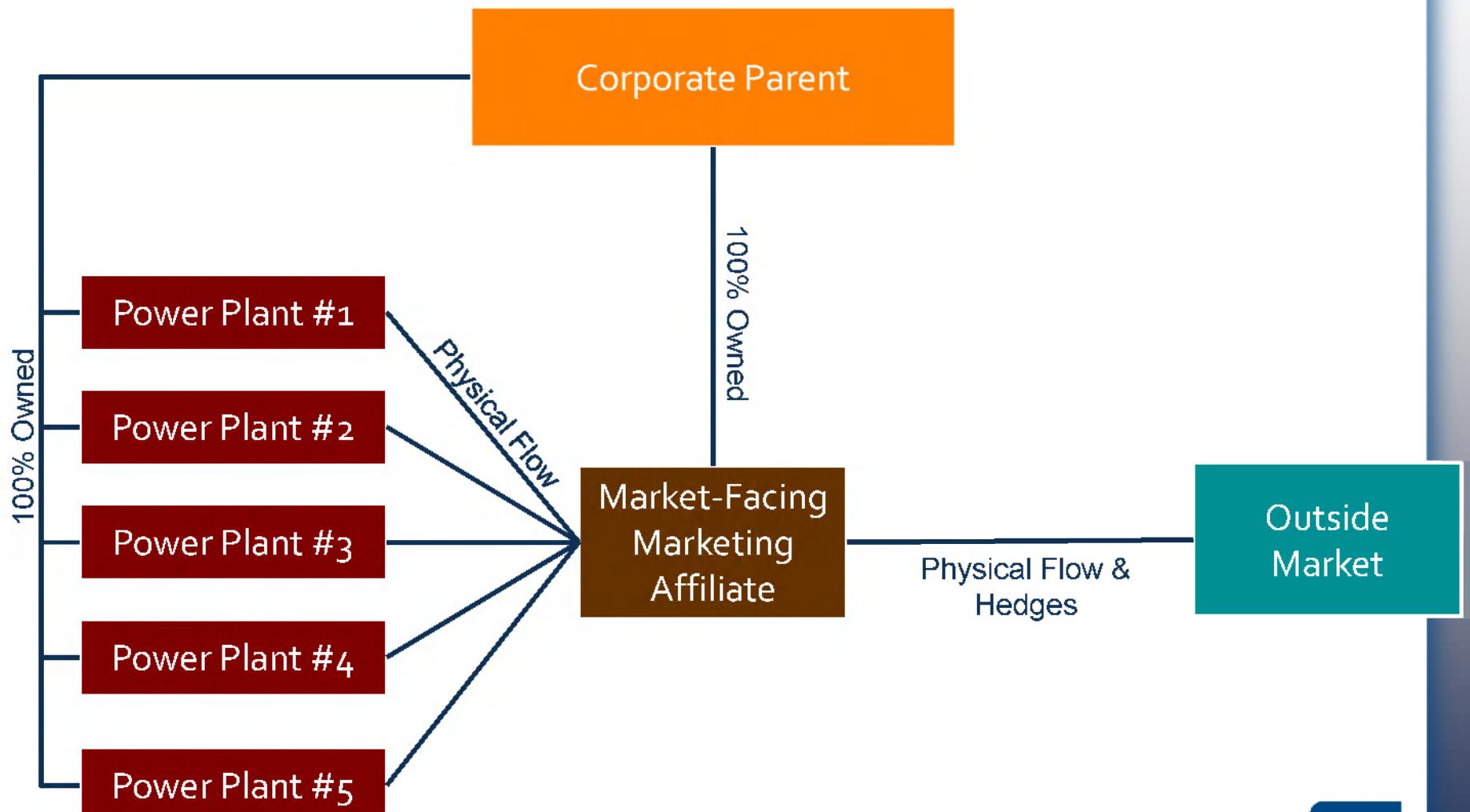
Proposed Changes to Reg Y

- In April 2012, the Fed proposed to amend the definition of “financial in nature” to include all forwards and derivative transactions involving “nonfinancial assets”, irrespective of whether such transactions are cash-settled, physically-settled, or involve transitory title.
- This change would essentially treat every transaction that is a physical forward involving any energy commodity as an activity that is “financial in nature” creating broad implications for market participants big and small in the energy and agriculture sectors
- To the extent proposed definition is adopted under Title VII, many energy companies and other end users could be considered Financial Entities affecting, among other things:
 - End-user status under mandatory clearing provisions (CEA – 2(h)(7) and 17 CFR Part 39)
 - SD & MSP required margin, minimum thresholds, margin calculations, form of eligible margin collateral, and haircuts, and collateral custody (under the proposed margin regulations) (proposed 17 CFR Part 23 and 12 CFR Part 237)
 - Eligibility for no-action relief for utility commodity swaps with special entities
 - Swap data reporting and confirmation time limits (17 CFR Parts 23 and 45)
 - Reporting party hierarchy for both swaps and historical swaps (17 CFR Parts 45 & 46)

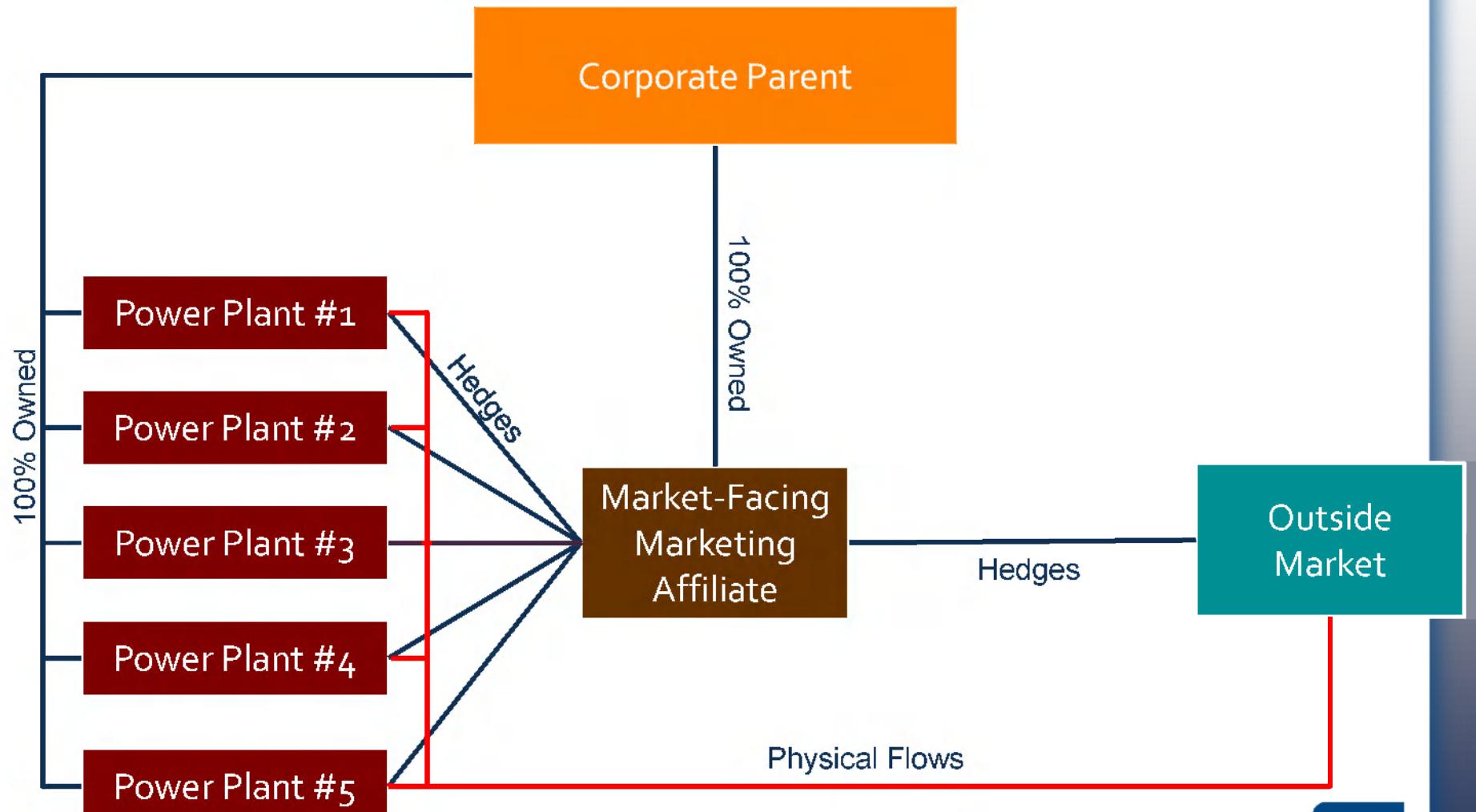


Market Structure Examples

Market-Facing Affiliate



Market-Facing Affiliate – Financial Hedging Only



Potential Consequences for Electric Industry of Proposed Rule



Potential consequences for electric industry of CFTC's use of expanded "financial entity" definition

- Unable to elect the end-user exception to clearing as intended by Congress
- Energy holding companies may have to restructure operations to continue to transact swaps without clearing

Potential Consequences Cont.

- A proposed rule for inter-affiliate swaps further restricts the end-user exception to clearing if the affiliate is a financial entity.
- Proposed rule requires cash margining and swap documentation
 - No centralized corporate treasury functions for interest rate hedging or currency hedging.
 - Energy Holding Companies have safely hedged their commercial risks for decades.
 - Posting cash margin between affiliates is all regulatory cost with no regulatory benefit.

Potential Consequences Cont.

- Proposed margin and capital rules impose more stringent requirements on “financial entities” that are end-users
- Electric industry would pay additional margin and capital charges when trading with registered “swap dealers”
- Additional costs offset no different risk to the “swap dealer” than a swap executed directly with the subsidiary that owns the power plant whose commercial risks the hedging subsidiary is hedging

Potential Consequences Cont.

- More immediate clearing and burdensome reporting under certain rules
- More burdensome swap portfolio reconciliation requirements
- Certain CFTC exemption orders and no-action letters are not available to “financial entities”
- Summary:
 - Significant cost burdens and regulatory requirements vs. no benefits.
 - Not Congress’s intent to burden energy companies with inapplicable regulations as if they were banks.
 - Congress intended to protect commercial risk hedgers.





Conclusion