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# Dodd-Frank And Energy Price Stability: Time To Rein In Unintended Consequences

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## Executive Summary

Congressional passage of the 2010 *Dodd-Frank Wall Street Reform and Consumer Protection Act* was intended to address the root causes of the 2008 financial collapse. Dodd-Frank's 848 pages have, via rule-making at the Commodity Futures Trading Commission (CFTC), ballooned into 14,000 pages of rules with only 40 percent of the new rules issued.

Swept into Dodd-Frank are the financial tools used by major energy producers and consumers to reduce business and consumer risks from the inherent volatility in the prices of primary energy commodities. The use of swaps and futures hedging by energy businesses had nothing to do with triggering the Great Recession. The fact that energy businesses use swaps is as relevant to global financial stability as gasoline use for lawnmowers is relevant to global aviation fuel supply. Less than 0.3% of the total swaps market involves energy transactions. Yet, Dodd-Frank disrupts and puts at risk long-standing and effective use of hedging and swaps to protect both businesses and consumers from energy volatility.

Disrupting effective price risk management in America's energy markets could not come at a worse time. The United States is undergoing a renaissance in the production of oil and natural gas, and collaterally seeing hundreds of billions in investments in new energy-producing and energy-intensive manufacturing enterprises, with the potential creation of millions of jobs.

Given that the original intent of the 1936 Commodity Exchange Act and the Commodity Futures Modernization Act of 2000 was never to discourage hedging, but to create a market and regulatory environment to maintain market integrity and ***promote*** the economic benefits of hedging-based risk management, Congress should as a minimum:

- **Exempt physical commodities businesses from being regulated as financial businesses.** Exempting physical commodities businesses from Dodd-Frank jurisdiction would be logical, economically beneficial and remove an unintended impediment to the budding American energy and energy-related manufacturing revival.

- **Remove CFTC's authority to arbitrarily reduce the $8 billion trigger for regulating energy swaps.**
  The CFTC ruled that $8 billion in annual energy trades is the *de minimis* activity triggering a firm's requirement to register under Dodd-Frank and is set to drop automatically to $3 billion in 2018, which will put at risk the exit of any remaining commercial energy swap activity. Congress should at least ensure that the relevant threshold for regulation does not automatically drop below current levels with no regard for future prices or market conditions. Any change in the registration trigger should require a formal rulemaking process and Congressional input.

- **Issue to the CFTC guidelines and standards to restrain ad hoc rule-making.** Imprecise language in Dodd-Frank has led the CFTC to promulgate inappropriate or ill-advised rules that fail to recognize damage to, and have eliminated long-standing effective energy market practices.

- **Immediately hold the CFTC to account to resolve and clarify critical jurisdictional conflicts.**
  The conflicting overlap between the CFTC and the separate authority of the Federal Energy Regulatory Commission is damaging to energy markets. Dodd-Frank required the two agencies to establish a jurisdictional Memorandum of Understanding: it is now almost three years overdue.

## 1. Introduction: America's Energy Renaissance

A renaissance began a decade ago in the U.S. energy sector, in particular in oil and natural gas. Moreover, while the unexpected and unplanned growth of the oil and gas sector is still expanding, it has already created greater economic and employment benefits than has any other part of the U.S. economy in recent years.

The U.S. is now the world's fastest growing, and soon, the world's greatest producer of oil and natural gas. The shale hydrocarbon revolution has driven a 45% reduction in oil imports[1] (with more to come), contributed over $400 billion a year to the U.S. economy[2], created over 1.7 million jobs[3], and attracted nearly $200 billion in foreign direct investment in America over the past five years alone.[4] The U.S. is now a net exporter of refined hydrocarbons and on track to become a net exporter of natural gas. All of this has not only started to dramatically erode America's crushing trade deficit but is also driving a revival in energy-intensive manufacturing industries.[5]

The resurgence in investments in energy-intensive manufacturing, from plastics to fertilizers, is driven by the fact that America now has, and is expected to continue to have, the world's cheapest fuels. Dow Chemical has identified more than 80 companies with over 100 new manufacturing projects coming on line.[6] An American Chemical Council analysis similarly catalogued that the energy boom has inspired nearly 100 chemical industry investments valued at over $70 billion due to come on line by 2017, and will generate over one million jobs and add over $300 billion to the GDP.[7]

The rapid growth in U.S. oil and gas production has not arisen from new discoveries or the opening up of off-limits federal lands. It has come from new technologies and techniques that have unlocked America's long-standing vast hydrocarbon shales. While "fracking" – hydraulic fracturing – is widely reported as the key to the revolution, the story is in fact one of deep industrial innovation combined with information technologies driven and deployed largely by small businesses.[8] It is a quintessentially American success story, and a permanent secular shift

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[1] *Reducing America's Dependence on Foreign Oil As a Strategy to Increase Economic Growth and Reduce Economic Vulnerability*, Furman & Sperling, Office of the White House, August 29, 2013.
[2] *Assessment of the Economic Impacts of the Shale Oil and Gas Boom*, Taheripour et al, United States Association for Energy Economics, 2013
[3] *America's New Energy Future: The Unconventional Oil and Gas Revolution and the US Economy*, IHS, 2013.
[4] *Foreign investors play large role in U.S. shale industry*, U.S. Energy Information Administration, April 8, 2013.
[5] *The Case For Exports: America's Hydrocarbon Industry Can Revive the Economy and Eliminate the Trade Deficit*, Mills, Manhattan Institute, May 2013.
[6] *Comments of the Dow Chemical Company Before the United States Department of Energy*, January 24, 2013.
[7] *Shale Gas, Competitiveness, and New US Chemical Industry Investment: An Analysis Based on Announced Projects*, American Chemical Council, May 2013

[8] *Unleashing the North American Energy Colossus: Hydrocarbons Can Fuel Growth and Prosperity*, *M. Mills*, Manhattan Institute, July 2012.

in the energy landscape now unlocking an unprecedented resurgence in energy-intensive manufacturing and process industries. All of this comes at a propitious time as the U.S. economy continues to struggle to recover from the Great Recession – an economic collapse, it bears noting, that was sparked by events entirely unrelated to the energy sector.

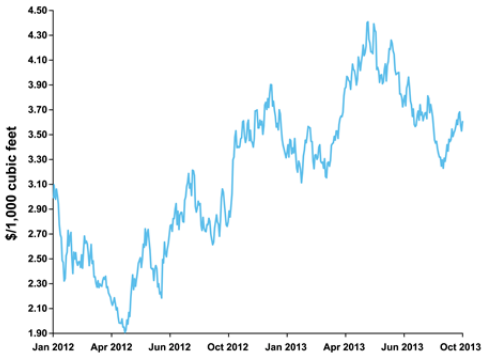
America's enormous and now rapidly growing energy-intensive industries necessarily depend on a continual and predictable supply of fuels.

## 2. Background: The Challenge of Energy Price Volatility

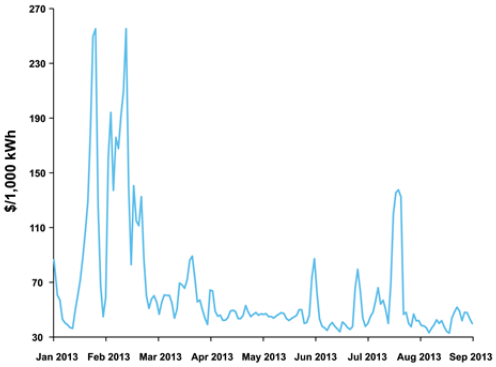
Primary energy prices vary continuously and largely unpredictably. For energy-intensive businesses, such as truck fleet operators, airlines, utilities or even breweries, energy price variations are unpredictable, can be financially damaging and even threaten business survival. An acceptable known future price – rather than gambling on lowest theoretical price -- is preferable to and vital for rational business planning and operations. Few consumers, whether buying energy itself or the services or products that are energy-price dependent, can tolerate the kind of price volatility, illustrated below, that is inherent in the underlying commodity.

***Energy Commodity Prices***

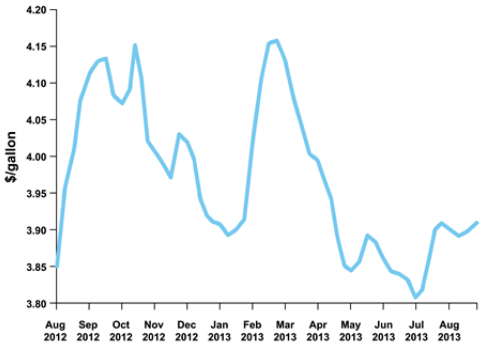
***Natural Gas***



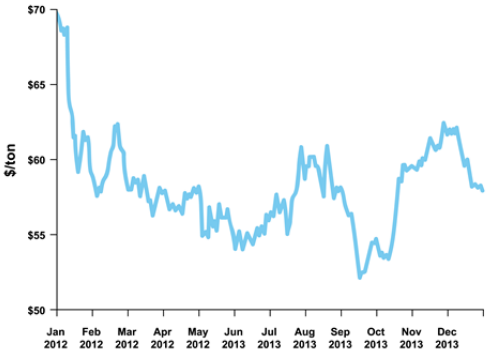

***Electricity***




***Diesel fuel***




***Coal***




*Data source: Energy Information Administration*

## 3. Overview: Tools To Manage Energy (And Commodity) Price Volatility

Price volatility in natural gas and oil markets has long been managed, or "hedged," using financial tools called derivatives (for example, swaps and futures). Nearly every type of business or organization that produces and purchases energy in significant quantities employs, either directly or indirectly, derivatives including electric utilities and wholesale power generators, oil and gas producers, refiners, municipalities, rural cooperatives, farmers, shippers, airlines, and manufacturers. As Rep. K. Michael Conaway, Chairman of the House Agriculture Subcommittee (where jurisdiction over commodities trading resides), has observed, "these are businesses that provide our daily goods and services, and rely upon derivatives contracts to manage the risks associated with their operations."[9]

When electricity markets were deregulated two decades ago, the first electricity futures market was introduced in 1996. Over 100,000 contracts were traded within a year. The migration to a commodity-based market for electricity was motivated by the central goal of increasing competition to achieve lower consumer prices. However, the potential for price volatility was obvious, as was the solution: "Electricity futures and other derivatives can help each of these market participants manage, or hedge, price risks in a competitive electricity market."[10]

Financial tools that allow one to "hedge" or "speculate" around commodity price uncertainty have been used for centuries (with some accounts tracing the practice back to early Greek civilization), whenever either sellers or buyers seek more predictable future prices. The Chicago Mercantile Exchange was created in 1898 to establish a standardized and efficient platform for hedging or "futures contracts," but at that time only for butter and eggs. Futures contracts, hedges and swaps now include virtually all agricultural and energy commodities, as well as foreign currency and interest rate fluctuations – essentially any traded good that exhibits the feature of unpredictable variations in future price.

A derivative contract – i.e., futures, options, swaps -- has a value tied to a specified variable (such as the price of another commodity, or a stock index, or interest rate) that will cause the contract to gain or lose value as the underlying index varies, regardless of whether the contract holder owns the underlying asset. Thousands of firms use derivatives to manage risk.[11] A business can protect against a future price increase in the commodity used by entering into a derivative contract that will gain value if that commodity's price rises. For example, Southwest Airlines used derivatives to insulate itself from the record rise in oil prices in 2008. Derivatives (or swaps) protect both the businesses and their customers from price shocks.

The swaps market is dominated by interest rate transactions – where parties exchange or "swap" the different risks associated with, for example, variable versus fixed rate loans. A related financial tool is the widely publicized credit default swap (CDS) that was considered one of the principle culprits in the 2008 global financial contagion. With a CDS the risk being managed or traded is the possibility of a lender defaulting on a loan. A CDS functions like insurance without being subject to insurance regulations. Interest and credit-related swaps account for over 90% of the derivatives market. We are interested here in energy commodities which, when the entire swaps/future market is counted including all other commodities combined, comprises 0.3% of the

[9] *CFTC Overreach Impacts End-Users & Leads to Higher Costs for Consumers*, House Agriculture Committee, July 24, 2013.
[10] *Primer on Electricity Futures and Other Derivatives, Lawrence Berkeley National Laboratory*, Stoft et al, Lawrence Berkeley National Laboratory, January 1998.
[11] *The Commodity Futures Trading Commission: Background and Current Issues*, Congressional Research Service, June 24, 2013.

total swaps/futures market.[12]

Roughly speaking there are two types of businesses that trade in energy swaps and derivatives: commercial businesses (such as utilities or airlines) that produce or handle physical commodities, and financial firms that do not. Financial institutions can engage in the same kinds of hedging contracts but without producing or taking delivery of the product, functioning as brokers or speculators. There can be some overlap between, say, an airline and a bank when the airline sometimes uses the hedging tools in a purely financial way, or if the financial institution (usually through subsidiary or arms-length investment) is involved in the ownership of physical commodities.

Daily operations, planning and investment for energy-centric commercial enterprises are all anchored in making assumptions about future energy prices. This is equally true for both energy producers and users. The business and consumer benefits of price visibility and certainty in commodities has long been a bedrock principle in economic theory and reality.

While commodities broadly, and energy in particular, were not the proximate (or even the remote) cause of the 2008 collapse, the 2010 Dodd-Frank Act -- motivated by the financial contagion caused by CDS trading -- has swept the energy sector under its jurisdiction. Given the role of financial institutions in triggering the financial collapse, it is understandable that there is now debate over how and under what circumstances banks should have direct ownership or control of physical commodities.[13] But regardless of the merits of arguments to modify or restrict the role of financial institutions in physical or energy commodity markets, it does not collaterally make sense that the commercial energy businesses that provide and use physical commodities should be regulated like financial institutions. Nevertheless, that is what has happened under Dodd-Frank.

## 4. Old Debate: Antipathy Towards Tools & Players that Manage Volatility

Public and legislative debate around commodity "speculation" in general and the use of derivatives predates the 2008 financial collapse. The use of and debate around "speculation" in commodities dates back to ancient Greece.[14] People and policymakers have been confused by and suspicious about derivatives trading for eons. In the 1890s the National Association of Farmers passed a resolution "condemning futures trading in wheat on the grounds that [it] lowered the price of wheat" and three weeks later the National Association of American Millers "passed a resolution condemning future [sic] trading on the grounds that it raised the price of wheat.''[15]

Scholars and financial analysts have studied the general practice of futures trading and hedging concluding that business and consumers benefit from more stable prices, and on average enjoy consequently lower prices and less volatility therefrom.[16] As one expert lucidly noted: "…there is no compelling theoretical or empirical case for limits on speculative derivatives positions. Indeed, there is not even a less-than-compelling case. … As a result, if implemented, the proposed position limits will impair the proper functioning of the commodity markets and

[12] Bank for International Settlements, June 2012; 0.3% includes all commodities
[13] *Examining Financial Holding Companies: Should Banks Control Power Plants, Warehouses, and Oil Refineries*? July 23, 2013 hearings before the Senate Committee on Banking, Housing, & Urban Affairs
[14] "How the Bank Lobby Loosened U.S. Reins on Derivatives," *Business Week*, Sep 4, 2013
[15] "Populists versus theorists: Futures markets and the volatility of prices," D. Jacks, 26 August 2005, *Explorations in Economic History*
[16] *Ibid* D. Jacks

produce no offsetting benefit."[17]

Nonetheless, the use of derivatives in energy domains continues to be a popular target. During the run-up in global oil prices from 2004 to 2008 the trope resurfaced that "speculators" were the primary cause of that price spike, not market forces of supply and demand. That (very old) populist position was articulated in a 2006 report from the U.S. Senate drawing an analogy between the oil price "bubble" and the dot-com stock bubble of Y2k.[18] But energy commodities are fundamentally different than stocks: the former are continuously consumed assets, the latter a "claim on future (and perhaps distant future, and certainly highly conjectural) cash flows, a commodity is consumed continuously in the here and now."[19]

The idea that "speculation" was to blame for driving up oil prices was debunked by many experts, notably in a comprehensive analysis from the St. Louis Federal Reserve concluding that speculators could at most have had a small (15%) impact on the '08 peak in global oil prices – a level of influence that would hardly seem to call for a complete restructuring of regulations around energy commodities.[20] Yet, energy markets have been targeted by regulators for expanded scrutiny and control apparently from the earliest days of the drafting of Dodd-Frank.[21] The Commodity Futures Trading Commission (CFTC) Chairman (where jurisdiction over commodities trading resides) has been quoted as specifically seeking to move energy commodities under stricter regulatory control citing the 2001 Enron collapse and a price-fixing case involving BP.[22]

The widely publicized Enron disaster was not the result of the use of derivatives, but it continues to be a rallying cry for increased oversight of energy derivatives, as does the 2004 case in which BP Products of North America unsuccessfully attempted to corner the propane market.[23] The BP episode was an example of the success of existing oversight, investigations and enforcement, (the operating unit was caught and fined) but hardly motivating a radical restructuring of all energy commodity markets - - which, to repeat, comprise under 0.3% of the total futures business. (Ironically, BP's attempt backfired and the company lost money on its inflated physical propane inventory.[24])

However, as enacted by Congress, Dodd-Frank encompasses energy commodities and leaves very broad discretion to the CFTC in how some 400 new rules will be written, opening the opportunity for "a crusade of rewriting many long-standing futures market regulations that Congress, via Dodd-Frank, never contemplated."[25] This past May, for example, six Senators from Western states wrote Commissioner Gensler citing again the BP propane affair and Enron and called for a more aggressive "interpretation" of Dodd-Frank because the "CFTC is failing to bring energy swap dealers under its oversight."[26]

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[17] "No Theory? No Evidence? No Problem," Craig Pirrong, *Regulation*, Summer 2010
[18] *The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back On the Beat*, Committee on Homeland Security and Governmental Affairs, June 27, 2006.
[19] *Ibid*, Pirrong
[20] "When Oil Prices Jump, Is Speculation To Blame?" *The Regional Economist*, Federal Reserve Bank of St. Louis, April 2012.
[21] How the Bank Lobby Loosened U.S. Reins on Derivatives, *Business Week*, Sep 4, 2013.
[22] *Ibid*
[23] "Record fine for BP over propane market scandal," Campbell, *Risk.net*, 26 October 2007.
[24] "Price Fixing Scandal Plagues BP," *Seeking Alpha*, July 17, 2006.
[25] Commodity Markets Council, Lance Kotschwar, testimony before the House Committee on Agriculture, on behalf of Commodity Markets Council, July 24, 2013.
[26] May 20, 2013 letter from Feinstin, Wyden, Cantwell, Merkley, Boxer, Murray.

## 5. New Debate: Dodd-Frank & Its Unintended, Or Hidden, Consequences

The 2010 *Dodd-Frank Wall Street Reform and Consumer Protection Act* is the most extensive financial industry reform in modern history. Dodd-Frank's 848 pages have via rule-making at the CFTC thus far ballooned into 14,000 pages of rules. While those pages contain 15 million words, as of this writing, barely 40 percent of the new rules have been issued.[27]

Dodd-Frank will impact every area of the financial market, but the largest set of rules is around derivatives – 5,000 of the 14,000 new pages of rules thus far relate to derivatives. Given the scope of the legislation it is understandable that there continues to be widespread debate over the challenges, confusion, and unintended consequences associated with such a massive and on-going overhaul and enormous expansion of the regulatory state.[28] The scope and challenge for both the regulated and regulators is evidenced by the fact that the CFTC has missed more than 60% of the legislated deadlines for action, and has held over 4,000 public meetings.[29]

The total universe of financial activity associated with the global swaps market is estimated at $600 trillion annually. But less than 0.3% of all swaps are associated with energy commodities.[30] It is not arguable that energy commodity swaps or "speculation" contributed to the 2008 collapse. The fact that energy markets employ swaps is as relevant to global financial stability as gasoline use for lawnmowers is relevant to global aviation fuel supply.

Nonetheless, while the energy sector had nothing to do with the 2008 collapse, Dodd-Frank has swept up all the financial tools used by major energy producers and consumers to reduce business and consumer risks from price volatility with far-reaching implications, and without examination of the potential downsides for consumers.[31, 32]

The 0.3% niche of the swaps market that involves energy divides into two broad issues: a) how banks should operate in regard to their involvement in energy commodities, and b) how businesses that produce and use energy can operate. We are focused here on the latter issue, and in particular, the unintended negative impact of effectively regulating energy businesses as financial institutions.

A diverse array of energy-using and energy-producing industries have testified before Congress and the CFTC regarding the financial and organizational burdens associated with Dodd-Frank. In Congressional testimony MillerCoors noted they were joined, in their objections in concerns, by such businesses as Coca-Cola, Novelis, Ball, Rexam, Dr. Pepper Snapple Group, Yuengling Brewing, North America Breweries, Rogue Brewery and Reynolds Consumer Products.[33] Hedging strategies are central to managing the risk in the "billions of dollars annually" spent by MillerCoors on commodities including barley, corn, natural gas, electricity and diesel fuel.

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[27] Davis Polk, Dodd-Frank Progress Report, September 2013.
[28] For summaries see: *Futurization of Swaps*, R. Litan, Bloomberg Government BGOV Analysis, Jan 14, 2013: StreetWiseProfessor blog, C. Pirrong, Director of Energy Markets, College of Business, University of Houston.
[29] See Davis Polk
[30] Bank for International Settlements, June 2012; 0.3% includes all commodities
[31] *The Potential Impact of Dodd-Frank on the Energy Industry*, Astofoli and Forrester, July 2011, Mayer-Brown.
[32] *Ibid*, Kotschwar
[33] Testimony of T. Weiner, MillerCoors, before U.S. Senate Committee on Banking Financial Institutions and Consumer Protections, July 23, 2013

Southwest Airlines testified before Congress that "hedging at Southwest is enterprise risk management--essential in our view given our $6 billion annual fuel bill. To hedge, we commonly enter into transactions many months or years in advance of needing the physical product. Trading in these illiquid markets allows us to manage our fuel costs, which in turn helps us to keep fares low and maintain large jet (Boeing 737) flights in the communities we serve."[34]

A consortium of eleven major trade associations representing suppliers of electricity, natural gas and oil has frequently testified on the unintended impacts of Dodd-Frank citing examples of specific consequences of energy operations being regulated like financial institutions, including: an independent gas exploration and production company that would have $700 million less to invest in production thereby eliminating 1,500 jobs and $1.9 billion of economic value to local communities; a public gas utility that would need to obtain a $500 million line of credit that would double the cost of interstate pipeline transportation and raise local distribution rates more than 10 percent; an electric power company that would face higher costs required a 5 to 15 percent customer rate hike; and a natural gas producer to divert 25 percent or more of its capital budget away from its core exploration and production activities.[35]

Dodd-Frank also impacts the use of hedging as a tool in America's farming sector. One of the farmer-owned hedging businesses testified that "the necessary investment to put in place and maintain a system to comply with the regulations would exceed not only any profits, but in many cases the total revenues of [the futures trading] branches -- to the point that those local branches could no longer provide brokerage services. The effect would be reduced risk management options, and their use, by farmers and ranchers."[36]

## 6. The Fallout: Big Energy Players Dodge But The Future Remains Uncertain

Under Dodd-Frank, the CFTC regulators created a new regulated entity, a swap execution facility (SEF), where they expected energy business that would become registered "swap dealers" would then undertake trades – instead of using the previous Over The Counter (OTC) market. The broad, diversified and loosely regulated but smoothly functioning OTC swaps market would be forced to migrate to highly-regulated, costly SEFs with each player a registered energy "swap dealer."

The shift to SEFs was expected because the CFTC now requires that any commercial business engaged in over $8 billion annually in commodity swaps become registered as a "swap dealer" -- in effect, to become a regulated financial institution with all the associated burdensome and expensive rules and procedures. But it didn't happen.

Essentially all of the swap transactions that would have been subject to regulation migrated away from OTC swap markets onto the existing, regulated "futures" exchanges.[37] As one industry newsletter put it, "in the energy markets, at least, it appears SEFs are dead and traditional futures exchanges have emerged triumphant."[38]

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[34] Testimony of C. Monroe, Southwest Airlines, before U.S. House of Representatives Committee on Agriculture Subcommittee on General Farm Commodities and Risk Management, July 24, 2013

[35] *OTC Derivatives Reform: Energy Sector Impacts*, 2010, American Gas Association, American Exploration & Production Council, American Public Gas Association, American Public Power Association, America's Natural Gas Alliance, Edison Electric Institute, Electric Power Supply Association, Independent Petroleum Association of America, National Rural Electric Cooperative Association, Natural Gas Supply Association, PJM Interconnection.

[36] Testimony of S. Cordes, before the House Committee on Agriculture Subcommittee on General Farm Commodities and Risk Management, July 24, 2013

[37] "Energy Swaps Migrating to Futures on Dodd-Frank Rules," *Bloomberg News*, Jan 25, 2013

[38] "Futurisation dooms energy swap execution facilities," *Risk.net*, June 19, 2013

Those businesses that are near or beyond the $8 billion trigger requiring registration have exited the over-the-counter swaps business and transferred all relevant business to the futures market. Thus far only three firms, BP, Shell and Cargill, have registered as swap dealers. It remains to be seen what the CFTC does in response. At least one CFTC commissioner has stated that these "block trades" in the futures exchanges "should not be a means to do an end-run around the intent of the [Dodd-Frank] law."[39]

Using the "futures" exchanges to hedge price volatility is, from a strict economic perspective, the same as using a swap. But there are differences. Instead of broad and diverse activities in OTC swap trades, all of the future hedging (again for companies trading over $8 billion annually) moved onto a small handful of registered futures exchanges, notably the Intercontinental Exchange (ICE) and CME Group (CME). Those exchanges are regulated and already have many of the "transparency" features Dodd-Frank sought. However, this means that all of the transactions are concentrated in a few exchanges – which by definition decreases the choice of both contract type and execution method.

In addition, for many entities and transactions the standardization of the contracts that is a characteristic of the futures exchanges is not feasible, thus the kind of specialization often characteristic in OTC swaps is lost, an issue particularly relevant for myriad smaller firms that engage in the OTC energy swaps market well below the $8 billion threshold. It is notable that the $8 billion threshold was arrived at arbitrarily.

Additionally, the CFTC plans to drop the threshold requiring registration from $8 to $3 billion in 2018. It is likely that whatever is left of the specialized, flexible and dispersed swaps business will be swept into the one-size futures exchanges, or simply not be undertaken. This, as earlier noted, will ultimately lead to higher and/or more uncertain consumer costs in energy-related domains. This is a transformation that leads into uncharted territory, that leaves open great uncertainties about potential negative impacts on businesses and consumer prices – and to repeat, involves transactions entirely unrelated to the ostensible motivation for the creation of Dodd-Frank.

## 7. Recommendations: Congress Needs To Rein In Dodd-Frank

It is probably too late to unwind the fact that the energy industry is now part of the complexities of Dodd-Frank. But it is not too late to ensure that regulators and the Congress avoid rule-making that creates unintended negative consequences in energy markets, specifically increasing the cost of managing price risks and ultimately the cost of energy and food.

The regulatory uncertainty associated with energy commodities could not come at a worse time. The U.S. economy continues to struggle to recover from the Great Recession sparked by events entirely unrelated to the energy sector. Meanwhile, it is the energy sector of the U.S. economy that has been booming with recent and dramatic gains in domestic oil and gas production. Adding uncertainty and confusion to the energy business is counterproductive for growth.

Given the delays, confusion, and by many accounts over-reaching interpretations of components of Dodd-Frank by the CFTC, all of the major energy trade associations along with major energy-using companies have called on Congress to not only amend the Act but also to provide clear and

[39] *Ibid*

defined procedures for challenging CFTC interpretations and rules in court.[40] Many critical rules issued thus far are interim and there is little visibility when action will happen (despite legislated deadlines) for over half of the rulemaking still mandated by Dodd-Frank.

The American Gas Association's Congressional testimony contains a trenchant summary of the problems with Dodd-Frank and energy commodities, an opinion echoed in many places in public and private. Any energy commodity can be substituted for "natural gas" in the following.[41]

> "Where does that leave us? There remain disagreements and confusion with the natural gas industry as to which types of gas supply transactions, if any, will be subject to CFTC regulation. These transactions are normal commercial merchandising transactions that parties use to buy and sell natural gas for ultimate delivery to end-use customers. They would not normally be considered speculate, financial transactions as the parties contemplate physical delivery of the commodity. Nevertheless, transactions that contain some option or choice for one or the other counterparty, raise questions for some as to whether they would be considered commodity options regulated as swaps, meet a three part test and a seven-part test to be exclude as options embedded in forward contracts, be viewed as trade options subject to a lessened reporting burden, or be considered facility use agreements that meet a three-part test and then a five-part test and not subject to regulation at all. Some counterparties in the industry have taken the view that regardless of whether a transaction would satisfy the seven-part test for options embedded in forward contracts, they will report all such transactions as trade options out of an abundance of caution to avoid the risk of violation of the CFTC's rules. Other counterparties have insisted upon contract provisions to force agreement as to the regulatory treatment of the transaction. Some AGA member companies, in the normal course of business, have entered into routine transaction with multiple counterparties where the different counterparties have conflicting regulatory interpretations of what are essentially identical contracts. Thus, normal contracting practices in the natural gas industry have been seriously disrupted."

None of this is good. None of it makes any sense. None of it was necessary to avoid a future systemic failure and repeat of 2008. None of it is relevant to the 99.7% of the financial activity in the markets that was the ostensible target of Congress in passing Dodd-Frank.

Given the long-standing use of swaps to manage volatility and unpredictability in commodities, and that the original intent of the 1936 Commodity Exchange Act was to encourage, not discourage, hedging for commodity risk management, it will be a challenge to ensure "no harm" from the rule-making still underway at the CFTC.

There are a wide variety of issues and challenges associated with proposed rules, ideas, or existing rules from the CFTC pursuant to that agency's interpretation of Dodd-Frank, all of which have been articulated in formal and informal venues by industry participants. Essentially all of the problems for the energy industry emerge from the same root cause – treating and regulating the energy businesses in the same fashion as financial institutions.

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[40] See for example: *OTC Derivatives Reform: Energy Sector Impacts*, 2010, American Gas Association, American Exploration & Production Council, American Public Gas Association, American Public Power Association, America's Natural Gas Alliance, Edison Electric Institute, Electric Power Supply Association, Independent Petroleum Association of America, Natrional Rural Electric Cooperative Association, Natural Gas Supply Association, PJM Interconnection.

[41] Andrew K. Soto testimony before the House Committee on Agriculture, on behalf of Commodity Markets Council, July 24, 2013.

Since the Commodity Futures Modernization Act of 2000 was never intended to discourage hedging, but to create a market and regulatory environment to maintain market integrity and ***promote*** the economic benefits of risk management, as a minimum, Congress should:

- **Exempt physical commodities businesses from being regulated as financial businesses.**

  Exempting physical commodities businesses from Dodd-Frank jurisdiction would be logical, economically beneficial and remove an unintended impediment to the budding American energy and energy-related manufacturing revival. Energy transactions by definition involve finite quantities of goods that are capable of being purchased in a competitive open marketplace. For that reason financial transactions among physical market participants representing interests in physical commodities do not produce the same risks as those representing an interest in intangible financial assets; physical commodity firms own sufficient physical assets to reasonably collateralize their trades.

- **Remove CFTC's authority to arbitrarily reduce the $8 billion trigger for regulating energy swaps.**

  The CFTC ruled by regulatory fiat, after public comment, that $8 billion in annual trades is the *de minimis* triggering the requirement for registration under Dodd-Frank. (Trades can total 10 and even 100 times the level of physical business.) That trigger is set to automatically drop to $3 billion in 2018 and would doubtless cause the exit of any remaining commercial energy swap activity. Congress should at least ensure that the relevant threshold for regulation does not automatically drop below current levels with no regard for future prices or market conditions. There should be no automatic or arbitrary reduction in a trigger without a formal rulemaking process, and Congressional input, allowing for a full airing of impacts as the full effects of Dodd-Frank are seen.

- **Issue to the CFTC guidelines and standards to restrain *ad hoc* rule-making.**

  Dodd-Frank's language is imprecise and over-broad in particular as it relates to energy businesses, leading to rules that fail to recognize, and damage or eliminate long-standing practices that are unrelated to the Act's intent to reduce systemic risk in financial markets.

- **Immediately hold the CFTC to account to resolve and clarify critical jurisdictional conflicts.**

  The CFTC now overlaps with the separate authority of the Federal Energy Regulatory Commission's longstanding role in commercial energy markets. Congress recognized the over-lapping jurisdiction and potential for confusion, and in Dodd-Frank directed FERC and the CFTC to develop a Memorandum of Understanding within 180 days of the Act's passage. It has been three years and no Memorandum has surfaced.

## About the Authors

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