

GEMI

“Energy Trading Conference”

Washington Issue Update

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Overview of Issues

- CFTC Reauthorization
- CFTC Budget
- CFTC – FERC Jurisdictional Dispute
- CFTC – SEC Merger Prospects
- Global Climate Snapshot
- Energy Bill

CEA/CFTC issues

- CFTF still not “reauthorized” since 2005.
 - Has been kept in operation by annual appropriations bills.

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- In current Congress, Senate included a CFTC reauthorization title in its version of the Farm Bill, but the House has not passed a CFTC bill (reverse situation in the prior Congress!)
 - The House Agriculture Committee did approve a CFTC bill which will be used to conference with Senate-passed version.

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- So Farm Bill politics will influence the prospects of CFTC reauthorization!
 - Farm Bill conference is locked up in controversy.
 - If the Farm Bill founders as a vehicle CFTC reauthorization could still move separately or on another vehicle (year-end Omnibus Appropriation in lame duck session or even in early 2009).

In general the Senate-passed CFTC bill and House Ag committee-report CFTC bill are very similar in concept.

- The two versions are viewed as “conference-able” in “Belt Way speak”

Common Provisions:

- PWG retail fx amendment
- Reauthorize CFTC for 6 years (2008-2013)
- Increased Criminal and Civil Penalties
- Extension of CEA §4(b) anti-fraud provision to principal-to-principal OTC futures trading
- New “Significant Price Discovery Contracts” Authority.

Bottom Line:

- Each of these has implications for energy trading

PWG Retail Fx Amendment

- Basically extends CFTC's anti-fraud authority to OTC retail fx trading by entities other than broker-dealers, FCMs, insurance companies and "otherwise regulated" types, and their affiliates.
- But House version would also create new regulation of "retail foreign exchange dealers" who deal primarily in retail fx:
 - Must have \$20 million net capitalization.
 - Must register with CFTC/NFA.

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- The Senate version also allows CFTC new rulemaking authority to expand this retail fx jurisdiction to cover abusive retail transactions in any “exempt” or “agricultural” commodity.
 - Energy? Natural Gas? Oil? Ethanol?
Precious Metals?
 - Orange juice? Wheat? Corn?

Increased Criminal and Civil Penalties:

CFTC Civil Penalty for Manipulation and other Violations.

- The greater of \$1 million or triple the monetary gain from violation

Exchange's Failure to Enforce Its Rules of Government:

- \$1 million per violation
- Felony offense for failure to comply with CFTC order to enforce rules regarding manipulation

Criminal Violations:

- Increase fine from \$500,000 to \$1 million for all violators
- Increase incarceration from 5 years to 10 years

Extension of §4(b) Anti-Fraud Authority:

- Extend existing anti-fraud authority over “agency” trades in off-exchange futures contracts to “principal-to-principal” trading in off-exchange futures contracts.
 - would extend to energy trading

“Significant Price Discovery Contracts”

- Response to Amaranth and ICE developments of a year ago.
 - Numerous House and Senate hearings on Amaranth case.
 - Strong, adverse political reaction and demands for CFTC action.
 - Levin: series of Senate investigations
 - Democratic Senators threaten to block CFTC bill on floor.
 - CFTC and ICE first resisted calls for more regulation, but eventually both got on board and supported need for new legislation.

CFTC proposed legislation to provide the agency new authority over “Significant Price Discovery Contracts”

- Essentially borrowed Core Principles in CEA for DCMs and DTEFs as relevant and appropriate for ECMs.
- Consistent with regulatory flexibility of CEA as amended by Commodity Futures Modernization Act of 2000.

Core Concept of CFTC proposal:

Qualifying contracts are subject to CFTC's discretion as to whether they perform a significant price discovery function under specified criteria:

- Price Linkage
- Arbitrage
- Material Price Reference
- Material Liquidity
- Other Material Factors

Price Linkage

Linked with a daily or final settlement price or other major price parameter of a contract listed for trading on a designated contract market (DMC) or derivatives transaction execution facility (DTEF)

OR

Linked with another “significant price discovery contract” traded on an electronic trading facility, to value a position; transfer or convert a position; cash or financially settle a position; or close-out a position.

Arbitrage

Extent to which the price is sufficiently related to the price of a contract listed for trading on a DCM or DTEF so as to permit participants to effectively arbitrage between the two markets on a frequent and recurring basis.

Material Price Reference

Extent to which on a frequent and recurring basis bids, offers or transactions in a commodity are directly based or determined by referencing the prices generated by contracts traded on the ETF.

Material Liquidity

Extent to which the volume of contracts in the commodity traded on the ETF is sufficient to have material impact on other contracts traded on a DCM or DTEF.

Other Material Factors

As CFTC determines by rule are relevant to whether a contract serves a significant price discovery function.

So, What is the Significance of Being a Significant Price Discovery Contract?

An ETF trading or executing such contract must comply with new obligation to meet eight CEA Core Principles:

1. Not Susceptible to Manipulation

- Contract cannot be susceptible to manipulation.

2. Monitoring of Trading

- ETF must monitor trading in the contract to prevent manipulation, price distortions and disruptions of delivery on cash settlement through market surveillance, compliance, and disciplinary processes, including conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.

3. Obtain and Report Information

- Ability to obtain information from market participants to perform any core principle functions; to provide such information to CFTC at its request; and to carry-out international information sharing agreements as CFTC may require.

4. Adopt Position Limits

- Adopt position limits or accountability for speculators in significant price discovery contracts where necessary and appropriate, to reduce market manipulation, price distortion, delivery disruptions or congestion, especially in the delivery month.

5. Emergency Authority

- The ETF must adopt rules for emergencies, including the ability to liquidate open positions in a significant price discovery contract and to suspend or curtail trading in such contract.

6. Daily Publication of Trading Information

- Price, volume, and other data on the contract as CFTC deems appropriate.

7. Compliance with Rules

- The ETF must monitor and enforce compliance with its rules applicable to any significant price discovery contract, including any limitations on access to the ETF for such contracts.

8. Conflicts of Interest

- ETF must establish and enforce rules to minimize conflicts of interest in its decision making processes, and to resolve conflicts.

Implementation of Core Principles

- The ETF has discretion to take account of differences between cleared and uncleared significant price discovery contracts in applying the Core Principles, and CFTC must take such differences into consideration when reviewing the ETF implementation of the Core Principles.
 - This was a very important feature to ICE.

Enactment of “Significant Price Discovery Contracts” will:

- Extend reach of CFTC’s jurisdiction to “linked” contract markets, i.e. ICE energy markets.
- Respond to political criticism raised by Amaranth experience.
- Provide legal certainty to both the ECMs and market participants.

CFTC Budget Update:

- CFTC makes case for more budget to cover more personnel and technology, especially for oversight and enforcement functions.
- New “Significant Price Discovery Contract” jurisdiction will create new resource demands.
- FY-09 request: \$130 million
- FY-08 funding: \$111 million

Administration again asking for implementation of transaction fee to reduce budget deficit

Proposal to collect a transaction fee on settlement of commodity futures, options on futures and other transactions cleared by derivative clearing organizations (would apply to cleared OTC contracts).

- Fee set at level to defray costs of CFTC's Market Oversight and Clearing, and Clearing and Intermediacy Oversight functions.
- Estimated at \$96 million for 2009 (would reduce federal funding of CFTC to \$34 million)

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- Repeatedly rejected by Congress.
 - Strongly opposed by exchanges and FIA.
 - Concerns with adverse impact on liquidity providers; futures industry already pays NFA fees for self-regulation; incentive to move trading abroad to escape any US transaction fee.

CFTC – FERC jurisdictional dispute



Walt Lukken

VS.



Joe Kelliher



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- Amaranth's legacy: Who has the jurisdiction?
 - Interest groups take divergent views.
 - Congressional supporters exist for both agencies.
 - Courts may have to resolve the dispute.

CFTC – SEC Merger?

- Not likely any time soon
- Treasury’s “Regulatory Blueprint” report on U.S. financial competitiveness due soon (end of March likely).
 - Competing for Treasury’s time and resources with other pressing matters such as sub-prime, credit crisis and housing crisis.

Global Climate

- Prospects for enactment of a Global Climate Bill
 - 2008: Very long shot
 - Legislative situation in House and Senate is far from being adequately developed.
 - Election Year Complications.
 - Enviro-Left opposition to “compromise” bill.
 - Bush veto?
 - Economic concerns:
 - already in recession?
 - EIA and EPA analyses expected soon
 - WTO issues: Gordian Knot?
 - But Democrats get to use issue politically in November elections even if they don't enact a bill this year.

2009 and Beyond: Better prospects than 2008

- McCain vs. Clinton/Obama: remove veto threat?
- Democrats increase House and Senate majorities?
- More time to develop key issues.

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- Restrict allowance trading to commercial interests?
 - National gas user complaints precedent.
 - “Speculator’s premium?”
 - Amaranth experience does not help.

Energy Bill in 2008?

- Major energy bill enacted in December 2007 “Energy Independence and Security Act”
- New CAFE standards and Renewable Fuel Standard (RFS)
- New electric efficiency standards affecting every aspect of residential, commercial and industrial use.
- But **NO** Energy Tax Package or Renewable Portfolio Standards (RPS)
 - Senate Republican successfully filibustered
 - President Veto

Alternatives Under Discussion

- 2008 Energy Bill
 - Legislative fatigue factor
- Energy Tax Package
 - Popular Items like Renewable Energy Tax Credits.
 - Major obstacle: Pay-GO
 - Administration opposes new taxes
 - Must find politically acceptable “pay-for.”

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- House passed Energy Tax Package last week of February using same oil and gas tax increases as led to veto in 2008.

QUERY: Can Senate get 60 votes to approve them?

RPS may be raised in context of Global Climate debate

- Makes more sense in that context
- Recent Texas electricity curtailment from drop in wind generation and colder weather

Ethanol Mandate: Revisitation?

- Lots of criticism of RFS
 - enviro critics mounting
 - Land and water impacts
 - global climate impacts
 - corn supply inadequacies and food market dislocations
 - cellulosic technology: when?