Contracts for Differences (Swaps): Concepts after the Dodd Frank Act
WSPP Operating Committee Training
New Orleans, October 2010

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Outline of the Hour

- What is CFD (swaps) (general overview)
- Post Dodd-Frank Regulatory Status
- Possible advantages to a WSPP contract format
- Other market options (ISO/RTO) and compare with Billateral or Exchang Cleared
- A more detailed explanation of hedging with CFDs
What is a Contract for Differences (CFD)?

- In finance, a CFD is a contract:
  - Between two parties, typically described as "buyer" and "seller"
  - Stipulates that seller will pay to buyer the difference between the value of a designated “asset” on the contract date and its value on a specified date, or buyer will pay seller if the difference is negative.
  - Some assert that a CFD is best called a Financial Swap.

- Purpose of a CFD:
  - Within our industry, CFDs allow market participants to hedge the risk of price volatility, seasonal volatility, load shaping, basis, migration risk, and much, much more. Depending on the purpose of the CFD, many use the product to “lock-in” or capture desired rates or returns on assets, load contracts, renewable contracts, etc.
  - More detail to follow in this presentation
Post Dodd Frank Regulatory Status

- Dodd-Frank Wall Street Reform and Consumer Protection Act captures swaps (including CFDs).
  - The Act applies to any “swap” transaction, which includes virtually every OTC derivative currently traded in the markets or other transactions that become known as swaps. Consistent with existing law, swaps do not include forward contracts (physically settled; delivery expected to be made and taken).

- Dodd-Frank Clearing Requirement.
  - The Act requires that all OTC swaps be cleared on an exchange, but...
  - “End-user exception” to this requirement applies where
    - End-user is not a financial entity, dealer, or major swap participant
    - Uses swaps to hedge commercial risk
    - Demonstrates to CFTC that it can meet its financial obligations associated with the non-cleared swap.
Position Limits

- The Act authorizes Commodity Futures Trading Commission (CFTC) to impose broad, aggregate position limits upon derivatives trading pinned to physical commodities.
- Purpose is to prevent excessive speculation and manipulation, protect liquidity and help assure accurate price discovery.
- Limits to be aggregated across markets and foreign boards of trade that provide access to US participants.
- Limits are imposed by rulemaking, are expected to apply to energy product swaps, and do not appear to apply to bilaterally traded (end-user) swaps.
Why Possible WSPP Facilitation?

- Some suggest that WSPP adopt a standard swap/CFD contract form for optional use. Possible advantages:
  - WSPP provides an immediate community of potential counterparties (end-users and financial houses) for risk management, separate and distinct from CFD products at clearinghouses.
  - Facilitating bilateral trades permitted by the Act will allow customization: the reason end-users sought the exemption in the first place.
  - WSPP approach has potential cost efficiencies of reducing bilateral negotiations over documentation.
Related Products: the CAISO IST (Inter-Scheduling Coordinator Trade)

- **What is the CAISO IST?**
  - A financially settled CFD, settled on one side with the CAISO and on the other with the counter-party. Examples.
  - WSPP MRTU Amendment and Western Energy Markets Working Group MRTU Settlement Amendment: Apply to Scheduling Coordinator to Scheduling Coordinator transactions where the buyer is its own Scheduling Coordinator. Are these still necessary?
  - Similar products in other RTO centralized markets: use has decreased due to increased bilateral CFDs.
Market Options Given the Regulatory Environment: Bilateral/Cleared/ISO Cleared

- Pros of Bilateral CFDs
  - Transparency and direct management of counterparty identity and creditworthiness
  - Liquidity: Position limits on cleared transactions could limit flexibility; bilateral transactions appear permissible over and above cleared limits
  - Eliminates risk of ISO uplift (socialization) of costs among ISO market participants arising from any participant’s default.
  - Eliminates ISO costs, including scheduling fees
Market Options: More...

- More Pros
  - CFD's can be traded in all tenors - Intra-day-Hourly, Balance of the day, Next-day, Next week, Bal-mo, Quarterly, Yearly
  - CFD's are not limited by an ISO offering
  - CFD's are not visible to all market participants and the ISO's in most cases

- Intertie Example:

- Cons of Bilateral
  - As a practical matter, margining is far less available
  - Direct credit exposure to counterparty
Risk Management Value of CFDs, a More Detailed Discussion

- Again, purpose of CFDs is risk management

- Hedging Portfolios
  - Permits “lock-in” of rates of return on assets, load sales, basis, intertie flows, etc.
  - Allows quick mitigation of losses without physical scheduling needs
  - Allows pegging price at any index point – generation nodes, hubs, load aggregate data, interties, etc. – without the need to physically schedule
Generation: Example of a LT Financial Hedge

- With a financial bilateral market, Generator “A” sells 100mws of 2011 – 2015 at market price $45 (a 14% rate of return on asset). Generator “A” is locking in a rate of return on their asset.

- Generator "A" is still obligated to physical comply with ISO rules and regulations associated with bidding and asset management.

- Because Generator “A” has fixed its return, it will be “indifferent” to the day-ahead clearing price or if the asset was accepted in the day-ahead market.
Load: Example of a LT Financial Hedge

- With a financial bilateral market, LSE “A” purchases 100mws of 2011 – 2015 at market price $45 (a 14% rate of return on load sales).
- LSE “A” is essentially locking in a rate of return on their load.
- LSE “A” is still obligated to physically comply with the ISO rules and regulations in serving its load obligations.
- LSE “A” will be “indifferent” to the day-ahead clearing price for serving up to 100mws of load.
CFDs and Risk Management, cont’d

- Basis Risk Management: Allows management of risk around energy, congestion and losses. CRR’s only allow management of congestion in the day-ahead and is limited to available mws in the auction (no HASP or real-time management of risk until convergence bidding).

- CFDs could allow for management of both congestion and losses in the day-ahead, HASP and real-time markets.

- Market participants may want to hedge all exposure to the basis between Mead intertie and Socal LAP.
  - Purchase 50mw’s of Mead to Socal LAP at $4.25
  - Essentially the counter party limits risk to congestion and losses between both the Mead and Socal LAP points in the day-ahead
  - This product can also be offered internally: Generation nodes to LAPs; and generation nodes to Hubs
Renewables Risk Management: Allows for the management of “shaped” products by using collars, put & calls, and imbalance accounts.

Allows for financial off-take agreements for funding using various financial clearing structures without the physical component and management:

- Basis hedging
- Intertie risk
- Variable energy risk – Schedule to Actual
- Load migration and Load growth
CFD Products - Overview

- Products may include:
  - Basis Hedging –Day-ahead, HASP, and Real-Time
  - Asset, Load and Intertie Management
    - Mitigating floating exposure
    - Fixing a rate of return
    - Managing seasonable risk
    - Load Sharing
    - Mitigation and load growth
Questions?

Questions? Discussion?

Thanks for listening