accenture

High performance. Delivered.

The Dodd-Frank Wall Street Reform Act

Implications for energy companies, utilities and other over-the-counter market participants

• Consulting • Technology • Outsourcing


HR
DIR
PRO
ADM

It was July 21, 2010 when President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. Fueled by the backlash of the 2008 financial crisis, this legislation represents the most sweeping overhaul of U.S. financial regulation since the 1930s. Even though the Act centers on the financial services and capital markets industries, it includes provisions affecting all public and private companies.

For companies engaged in commodities hedging or trading the most significant aspects of the Act are the rules regulating the over-the-counter (OTC) market. Commonly referred to as "derivative reform," these rules are far-reaching and complex. As written, derivative reform addresses all types of swaps: equity, interest rate, foreign exchange, credit default and commodity. For energy companies trading OTC commodity swaps there are four major areas to evaluate for business impact: clearing, data and reporting, position limits and new business conduct rules. Since no current OTC market participant will be left untouched, it is still imperative to understand the full scope of these regulations (see caption below).

While the specific rules of derivative reform have not yet been fully promulgated, and much is uncertain about the details of complying with Dodd-Frank, enough is known to assess the impact this legislation will have on companies which enter into OTC contracts today in the energy sector.

Non-financial industries which participate in the OTC derivative markets include:

- Energy Companies
  - Supermajors
  - Independent Oil & Gas
  - Refining & Marketing
- Electric and Natural Gas Utilities
- Chemical
- Mining and Mineral
- Airlines
- Agribusiness
- Consumer Products

What is a swap dealer and a major swap participant?

The Dodd-Frank Act defines a swap dealer as any person who:

- Holds itself out as a dealer in swaps;
- Makes a market in swaps;
- Regularly enters into swaps with counterparties in the ordinary course of business for its own account, or engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps.

With these characteristics:

- Tends to accommodate demand for swaps from other parties;
- Is generally available to enter into swaps to facilitate other parties' interest in entering into swaps;
- Tends to enter into swaps on their own standard terms or on terms they arrange in response to other parties' interest; and
- Tends to arrange customized terms for swaps upon request, or to create new types of swaps at their own initiative.

A major swap participant satisfies any one of the following criteria:

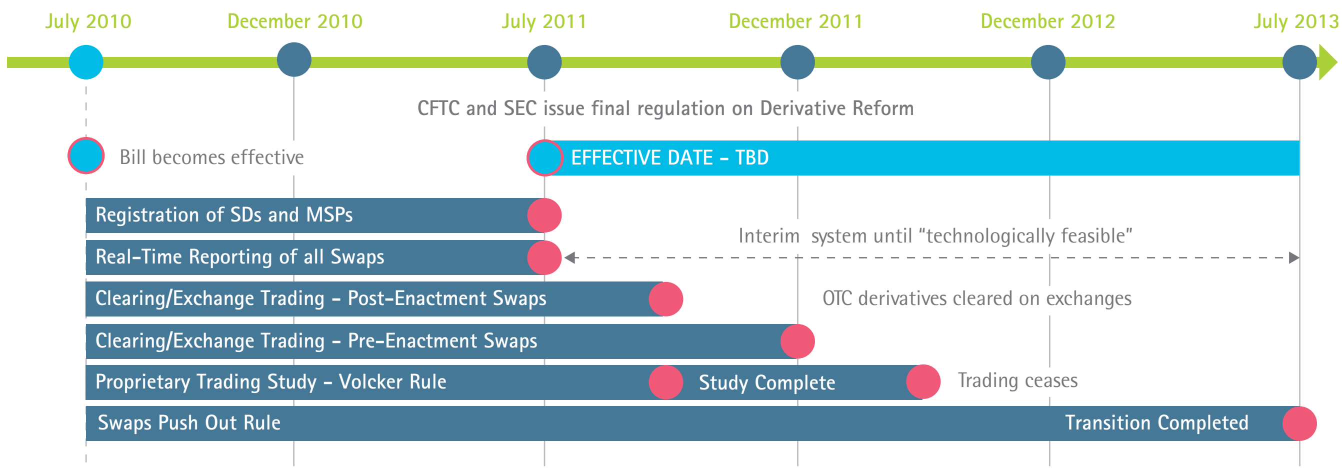
- Maintains a "substantial position";
- Holds outstanding swaps which create "substantial counterparty exposure"; or
- Is a highly leveraged financial entity that maintains a "substantial position".

End-users enter into swaps to hedge or mitigate commercial risk.

Many moving parts

Figure 1. Timeline for Derivative Reform Implementation

The original timeline for Derivative Reform is aggressive. Market participants are arguing for a phased approach to allow for an orderly, efficient and inclusive transition to the new market.



CFTC is signaling that a phased approach to implementation will be contemplated.

European regulators are looking to the U.S. regulatory framework for its design; in general, however, new European regulations will likely be phased and implemented over 8+ years.

There are many moving parts to derivative reform. And even though comments are still being received, studies are underway and the rules not yet official, the picture is becoming clearer each day (see Figure 1).

For example, market participants whose swaps must now be cleared through a central counterparty clearing house will incur increased costs to support OTC activities in terms of the cash required to post margin and collateral for cleared swaps. Other organizations will need to invest in corporate governance and leading enterprise risk management practices, including enhanced credit risk management, in order to comply with the new regulation. All participants should assess existing technology for data and reporting requirements.

With much at stake, it is critical that companies get this right the first time. While many affected market participants have been active on the advocacy front, finding opportunity in and meeting the requirements of Dodd-Frank require that companies begin to prepare now. Accenture recommends that 1) organizations assess the potential impact of Dodd-Frank on their objectives and their organization, especially with regard to swaps clearing, data and reporting, position limits and business conduct rules; 2) companies assess their governance, people, processes and technology to identify any gaps between their capabilities and the requirements and opportunities presented by Dodd-Frank; 3) finally, companies create a roadmap to capture opportunities and close any gaps to compliance.

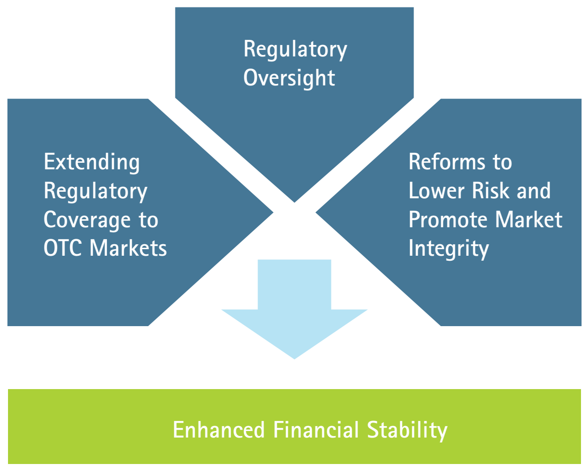
Derivative reform in brief

Figure 2. Key Provisions of Dodd-Frank Derivative Reform

The scope of the bill is far reaching and brings into effect a number of new regulations pertaining to any bank or non-bank institution that poses a threat to financial stability. Derivative reform will impose new requirements for energy companies that participate in the OTC market.

- CFTC given primary financial regulatory agency authority for commodity derivatives

- Standardized derivatives must trade on regulated exchanges or swap execution facilities



- Capital and margin requirements
- Robust business conduct standards
- Recordkeeping and reporting requirements
- Real-time public reporting
- Position limits
- End-user exception

- Transparent trading of swaps will increase competition and bring better pricing to the marketplace

The bill brings into effect a number of new proposals for regulating any bank or non-bank institution that poses a threat to financial stability. Derivative reform, a key component of the Act, will impose demanding new requirements for energy and utility companies who participate in the OTC commodity market—which will be regulated by the Commodity Futures Trading Commission (CFTC).

The 1980s ushered in the wave of derivative activity that led to the enormous derivative markets we see today. OTC swaps, options and other instruments were created that allowed corporations to hedge exposure to and speculate in exchange rates, interest rates and commodities prices. The OTC market continued to grow—unabated, unregulated and opaque. Today U.S. derivatives trades are estimated to be a $300 trillion dollar market.

In response, Congress passed the Dodd-Frank Act. The aim of the Act, as the bill states, is "To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes." In an effort to accomplish this, the Act changes the existing regulatory structure in several ways. Among them: creating new oversight agencies and combining others; increasing market transparency; and increasing oversight of institutions deemed to be systemically risky.

The new or altered agencies are granted explicit power over certain financial markets. They are required to report annually or biannually to Congress on current progress and future goals. The Act is categorized into sixteen titles, and by some estimates, requires that new or altered agencies create as many as 243 rules to implement the entire scope of the Dodd-Frank legislation.

The specifics of how the Act will be implemented are still being determined. Some provisions take effect immediately, while others require study and comment periods. But all provisions are expected to be implemented by the end of 2013, or as soon as technologically feasible. Recently the public debate has broadened to include concerns that it might be better to pause or phase in implementation rather than risk market disruptions that could result from a hurried process.

The goals of derivative reform

Close regulatory gaps

The 2008 financial crisis has been blamed on irresponsible risk-taking by financial institutions investing in credit default swaps traded in the largely opaque and unregulated OTC market. The Act provides the Securities and Exchange Commission (SEC) and the CFTC with new authority to regulate OTC commodity derivatives.

Central clearing and exchange trading

The legislation sets up a mechanism for clearing OTC transactions through designated swaps exchange facilities and clearing organizations. The argument for clearing through central counterparties (CCPs) is that this pooling of credit risks will reduce systemic risk in the U.S. financial system. This applies to standardized swaps that have been approved by the CFTC for clearing through these types of organization.

Market transparency

The new law requires data collection and publication through clearing houses or swap data repositories (SDRs) to improve market transparency. Another key objective for the CFTC is to provide greater price transparency and, therefore, liquidity for all market participants. It also provides regulators with important tools, such as the establishment of position limits, for monitoring and responding to risks.

Financial safeguards

In the absence of clearing, safeguards are added to the system by ensuring that OTC commodity market participants have adequate resources to meet financial obligations due under the swap. Indeed, additional duties to counterparties are required of swap dealers and major swap participants such as verifying a counterparty's eligibility to transact in the swap market, providing a daily mid-market value of uncleared swaps to a counterparty and obtaining documentation from an end-user exercising its right for an exception from clearing.

Higher standard of conduct

A standard code of conduct is established for all registered swap dealers and major swap participants. The Act provides for an enhanced internal risk management governance structure and focus within the organization from the front/ middle/ back office all the way to the Board of Directors.

CFTC Chairman Gary Gensler put it this way:

"The Wall Street reform bill will–for the first time–bring comprehensive regulation to the swaps marketplace. Swap dealers will be subject to robust oversight. Standardized derivatives will be required to trade on open platforms and be submitted for clearing to central counterparties. The Commission looks forward to implementing the Dodd-Frank bill to lower risk, promote transparency and protect the American public."

(Comments on Enactment of Wall Street Reform and Consumer Protection Act, CFTC Chairman Gary Gensler, July 21, 2010).

The impact of derivative reform

Not all of the rules have been drafted and there is ambiguity in how the rules will be implemented, but one fact is clear. Any company that participates in the OTC markets cannot escape the effects of Dodd-Frank. Large or small, whether a significant player who makes markets, manages a large swaps position, trades speculatively and enters into OTC transactions on behalf of others or a small user who enters into a few transactions a year to hedge risk, the Act's requirements apply.

Nor should businesses delay analysis and action until there is complete certainty about the Act. Because it is so material and far-reaching, now is the time to begin to assess just what derivative reform may mean to your business.

Following are a few of the most important areas of reform in the legislation.

1. Swaps Clearing (Proposed rule)

One of the critical aspects of derivative reform is the requirement that all swaps which are clearable be cleared through a designated clearing organization or swaps exchange facility, unless those swaps can be exempted for bona fide hedging purposes. Clearable swaps are those that have been approved by the CFTC for clearing and are standardized. This rule applies to all market participants, regardless of size and market penetration.

The proposed clearing rule has significant impacts on market participants. First, because swaps will be cleared, margin and collateral must be posted to the clearing house to protect it in the event of default. This is much the same as posting margin on futures transactions today. But it is in contrast to OTC collateral provisions now in existence, which generally only require posting of collateral in the event of a credit downgrade or other adverse credit event on the part of one of the participants. And, even in the event that collateral is required, collateral other than cash is often offered and accepted. Taken in the extreme, the funding implications of this rule could change entire business models.

A second impact of the derivative reform is the increased organizational support needed to calculate, track and pay/receive margin amounts which were previously un-margined. This means additional resources with specialized knowledge, and, likely, additional software to support the margining activity.

A third impact of clearing is reserved for those entities seeking the end-user exception. Under derivative reform, an entity may claim an exception from clearing if the swaps are used to hedge or mitigate commercial risk. The definition of hedging includes any swaps position that meets the bona fide hedge rules under the

Commodity Exchange Act, meets hedge qualifications of the Financial Accounting Standards Board Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133), or is appropriate to reducing the risks from the ordinary course of business.

A high level of expertise will be required to prove that hedges are, in fact, hedges. Processes must be implemented to ensure that, at the time a swap is executed, information regarding the methods used to mitigate counterparty credit risk in the absence of clearing is provided to the swap data repository along with the other information about the swap itself. Pertinent facts to be included would be whether an affiliate or financial entity is involved, the identity of the end-user, and a statement that the swap is being used for hedging purposes.

The rule requiring that swaps be cleared will mean all market participants will incur costs as they implement changes to people, processes, and technology. Additionally, market participants whose swaps must now clear will find that significant margin and collateral postings will be required to support their derivatives activity.

2. Data and Reporting (Proposed rule)

Data

The new legislation includes a group of rules governing data collection and transaction reporting. These rules apply to all market participants, with special provisions for participants classified as swap dealers and major swap participants.

First, the rules establish a new registered entity, the swap data repository, to collect and maintain data and information related to swap transactions. The data collected by this entity will be made available directly and electronically to regulators. Second, the CFTC will prescribe standards for swap data recordkeeping and reporting, applicable to both registered entities and counterparties involved with swaps. These are to be comparable to those for clearing organizations.

A swap dealer and major swap participant will be required to:

- "make such reports as are required by the Commission by rule or regulation regarding the transactions, positions and financial condition of the registered swap dealer or major swap participant;"

- keep all books and records open to inspection and examination by any representative of the Commission; and

- maintain a "complete audit trail for conducting comprehensive and accurate trade reconstructions" including daily trading records of the swaps identifiable by counterparty and all related records (including records of related cash and forward transactions) and recorded communications, including electronic mail, instant messages, and recordings of telephone calls.

For all swap participants, the proposed rule calls for the reporting of swap data from each of two important stages of the existence of a swap:

- the creation of the swap; and

- the continuation of the swap over its existence until its termination or expiration.

Registered entities and swap counterparties must report required swap creation data electronically to an SDR. Required swap creation data means all primary economic terms data and all confirmation data for a swap. Swap counterparties must also report required swap continuation data electronically to SDRs over the swap's existence until final termination or expiration.

Combined, these rules mean that: 1) the CFTC will define the types of data to be held by SDRs; and, 2) all swap counterparties will collect the data and make it available to SDRs.

Reporting

The CFTC is proposing rules, for all participants, to require public real-time reporting of certain swap transaction pricing and volume data. It also would establish a procedure for determining appropriate minimum sizes for block trades and large notional swap transactions. The proposed rules require that parties to a swap report swap data to a real-time disseminator, which would be either an SDR that accepts data for the particular asset class or a third-party service provider. Such a report must be made as soon as technologically practicable.

Meeting the demands of the data and reporting rules will require investment in technology, data warehouses and processes. Not only to capture the data required, but also to report the data in the time and fashion required by the CFTC.

3. Position Limits (Proposed rule)

In response to "too big to fail", derivative reform will expand current positions limits and institute new to-be-determined position limits. The proposed position limits will be for spot positions and non-spot positions. Limits will be created in single instrument swaps, cross-commodity and cross-time swaps, and all other OTC instruments. Additionally, aggregate limits will be set for the combination of exchange-traded futures and OTC positions. An exception to these limits exists for those entities that can prove that their OTC activity is for bona fide hedging purposes.

What might additional margin and collateral requirements mean to your business?

(Note: Recent signals from certain regulatory agencies indicate that non-financial company end-users may be exempted from margin and collateral requirements.)

Consider the case of an energy producer who hedges in OTC markets to lock in margins. If the company's credit is good, it posts little if any collateral on these hedges and is free to invest cash into exploring new production. Now, assume that all of these hedges are margined on a daily basis; and instead of having cash to invest in exploration, the company must invest that cash in margin requirements. Now the company has a choice to make. Does it forego hedging and accept wide variability in cash flows so it has sufficient liquid reserves available to invest in exploration, or does it completely revise its operational strategy so that it can afford to hedge and invest in exploration?

Likewise, an integrated electric utility will need to assess capital allocation to and business strategies for its unregulated merchant energy business. In the past, the collateral and credit support required for its OTC transactions were based on the company's credit rating. Now, with daily margin requirements, the cash needs for its trading or generation business unit will fluctuate with market prices requiring greater liquidity management at both the parent and the affiliate company level. To the extent that the energy merchant makes a market in swaps for other OTC participants, that entity will be registered as a swap dealer subject to additional regulatory oversight.

The limits have implications in two areas. First, a swap participant may find that activity conducted today may be limited in the future. This could lead to changes in business strategies due to market limitations. It could also mean potential organizational changes to allow for segregating positions among legal entities to facilitate business objectives. Second, a participant will be required to create internal oversight and compliance functions to monitor compliance with CFTC limits. The risk management organization in conjunction with the back office will validate bona fide hedge positions which are deducted from any position limit imposed as well as respond to calls for information from the CFTC. Also, a participant's system will need to facilitate the collection of position data in a manner consistent with mandated position limits.

4. Business Conduct Rules (Proposed rule)

A swap dealer and major swap participant will be subject to conduct standards in dealing with counterparties as well as in internal business practices. In general, these entities will be held to a much higher external standard when dealing with counterparties. New duties and obligations include:

• verification of a counterparty's eligibility to enter into a swap transaction;

• disclosure of the risks, characteristics, incentives and conflicts of interest related to a particular swap;

• provision of a daily mid-market value of uncleared swaps to their counterparties; and

• notification to the counterparty of its clearing rights.

New verifications and additional disclosures will require changes to the deal-making process. Creating and negotiating new master trading agreements will require additional legal, contract administration and commercial efforts.

From an internal conduct standpoint, the bar is also raised for major swaps participants and swaps dealers. The proposed rules feature numerous business conduct standards which touch aspects of responsibilities in the front, middle and back offices. The most significant of these rules are:

• creating a Chief Compliance Officer, with "appropriate background and skills to fulfill his or her responsibilities" reporting to the Board of Directors or senior executive, and responsible for ensuring and certifying compliance with the provisions of derivative reform;

• establishing a risk management program consisting of written policies and procedures designed to monitor and manage the risks associated with day-to-day business;

• monitoring of trading including providing annual training for personnel, diligently monitoring and supervising trading, implementing an early warning system for testing limits, testing position limit procedures, documenting compliance with position limits on a quarterly basis and auditing the procedures annually;

• diligent supervision of all activities performed by all employees and agents, requiring the creation of a supervisory system with qualified supervisory personnel;

• establishing a business continuity and disaster recovery plan designed to enable the business to resume operations by the next business day following an emergency or other disruption; and

• adopting policies and procedures prohibiting any action that results in any unreasonable restraint of trade or imposes any material anticompetitive burden on trading or clearing.

What does all of this mean? Simply put, business conduct standards, whether internal or external, will be more rigorous for major swap participants and swap dealers. Similar to the implementation of Sarbanes-Oxley, but perhaps even larger in scope, companies will need to implement processes, organizational changes, new roles and responsibilities, and new technologies in order to comply.


value
8143
AP
695
24,490
118,866
(4,459)
11,043
8
9

How companies should respond

Energy and utility companies engaged in the OTC commodity market can ease the burden of compliance to the Dodd-Frank Wall Street Reform Act by assessing, sooner rather than later, current business objectives and organizational model against the new regulatory requirements. A key objective is to determine where new regulations impose constraints on current operating models and where new regulation may provide opportunities for better risk-adjusted strategic decisions.

For each of the areas affecting all OTC commodity market participants – clearing, data and reporting, position limits and new business conduct rules – companies should start the process by asking the following questions to understand what gaps currently exist in order to plan for a logical transition to a desired end state.

• What portion of the trade portfolio is currently traded and cleared on exchanges?

• How much uncleared OTC activity will move to clearing and be subject to margin requirements?

• Is any part of the organization a swap dealer or major swap participant?

• What additional processes or technology will be required to meet the data and reporting requirements?

• Can positions be aggregated across all books by product, location and time periods within and between organizational units?

• Can hedge positions be validated at trade execution and excluded from the aggregate portfolio?

• How well do existing credit risk management practices measure daily counterparty exposure?

• How well would the existing enterprise risk management governance structure comply with the additional external and internal business conduct standards for swap dealers and major swap participants?

Organizations which institute enhanced or leading industry risk management practices will have less difficulty transitioning to the new regime. Furthermore, it is imperative that energy and utility companies improve their overall data capture and management. Enhanced credit support for derivative transactions will require greater integration between corporate finance and the business use of derivatives, as daily margining puts greater constraints on cash management. To manage external reporting requirements going forward, companies will need to apply a higher level of focus and rigor to the quality and maintenance of data across the full suite of enterprise risk management activities from front to back office, across business units and upward to the corporate finance and compliance functions.

As a result, high performing companies will accelerate the process of integrating the risk and finance functions. The Chief Financial Officer and the Chief Risk Officer must work from a single set of information and share an understanding of the interrelationships among credit, market and operational risk. Enterprise risk management must become a reality rather than a stated objective. Risk must be seen as a growth and profitability enhancing capability, not as a back office or compliance-centric function.

For these reasons, Accenture recommends that clients tackle these derivative reforms holistically by developing a master plan and making one set of business, technology and data changes across the enterprise. Companies that do this will have the critical insight and the competitive platform they need to stay one step ahead in the new financial landscape.

Accenture can help

At first glance, the rules imposed on the OTC market by the Dodd-Frank Act derivative reform can seem daunting. And certainly continued dissection and study will be required.

Clearly, change is here. And companies that embrace and plan proactively for the new environment will compete more effectively than those who decide to wait and see.

Accenture can help as you respond to the changes that come with regulatory reform. We can work with you to transform risk management into a value-enhancing capability. Risk management becomes then a competitive differentiator to:

- Align business strategy and risk capabilities to evaluate market options and drive profitable growth;

- Embed risk management capabilities across the organization to support a risk conscious culture;

- Adapt to industry and geographic regulations in a holistic manner while focusing on the business impacts and outcomes;

- Provide the capabilities to collect, model and analyze business information for better risk-based decision making.

That level of risk management capability can position the company for higher economic returns, improved shareholder value and increased stakeholder confidence. The prize to be kept in view is growth and better business performance, while protecting the interests of shareholders and other key stakeholders.

Uncertain economic times call for no less. For companies that want to respond successfully to the demands of the time, and to seek its opportunities—the time to prepare is now.

About the Authors

Shelley Hurley

Shelley is executive director – Risk Management, and Global Resources lead. Based in Austin, Texas, Shelley has over 30 years of global, industry and consultancy experience in the energy, resources and metal sectors as a trader, managing director and NYMEX seat holder. Her previous roles as Chief Risk Officer and founder of the Committee of Chief Risk Officers in the resources sector and extensive experience in risk management, credit risk management, operational risk management, trading and performance management helps executives from multinationals across the energy and resource sectors become high-performance businesses.

Margarita Jannasch

Margarita is principal - Risk Management, based in Houston, Texas. Margarita brings 20 years of combined industry experience in energy upstream planning and economics, wholesale energy merchant mid-office risk controls, international energy project risk management and integrated electric utility enterprise risk management, governance and strategy. Margarita has served in Risk Management executive leadership roles where she implemented and managed formal Risk Committees, risk processes and standards. As Accenture's Resources Risk Management subject matter expert in regulatory reform and compliance, she helps companies become high-performance businesses.

Source: CFTC Proposed Rules for Dodd-Frank (www.cftc.gov)

About Accenture Management Consulting

Accenture is a leading provider of management consulting services worldwide. Drawing on the extensive experience of its 13,000 management consultants globally, Accenture Management Consulting helps clients move from issue to outcome, with pace, certainty and strategic agility. We enable companies and governments to achieve high performance by combining broad and deep industry and functional offerings and capabilities across seven service lines: Customer Relationship Management, Finance & Performance Management, Process & Innovation Performance, Risk Management, Talent & Organization Performance, Strategy, and Supply Chain Management.

About Accenture Risk Management

Accenture Risk Management consulting services work with clients to create and implement integrated risk management capabilities designed to gain higher economic returns, improve shareholder value and increase stakeholder confidence.

About Accenture

Accenture is a global management consulting, technology services and outsourcing company, with more than 215,000 people serving clients in more than 120 countries. Combining unparalleled experience, comprehensive capabilities across all industries and business functions, and extensive research on the world's most successful companies, Accenture collaborates with clients to help them become high-performance businesses and governments. The company generated net revenues of US$21.6 billion for the fiscal year ended Aug. 31, 2010. Its home page is www.accenture.com.

Disclaimer

This document is intended for general informational purposes only and does not take into account the reader's specific circumstances, and may not reflect the most current developments. Accenture disclaims, to the fullest extent permitted by applicable law, any and all liability for the accuracy and completeness of the information in this document and for any acts or omissions made based on such information. Accenture does not provide legal, regulatory, audit, or tax advice. Readers are responsible for obtaining such advice from their own legal counsel or other licensed professionals.

ACC11-0472 / 11-2972

1 2 4 5 8 7 1 6