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DELIVERED VIA ELECTRONIC MAIL
Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Nova Scotia Securities Commission
Ontario Securities Commission

c/o:
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c/o:
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Dear Sirs/Mesdames:

RE: Comment Letter to CSA Staff Notices 91-303 and 91-304 –*Proposed Model Provincial Rule on Mandatory Central Clearing of Derivatives and Model Provincial Rule – Derivatives: Customer Clearing Protection of Customer Collateral and Positions*

Capital Power Corporation, CP Energy Marketing LP, CP Energy Marketing (US) Inc. and their other affiliates and subsidiaries (collectively, "**Capital Power**") make this submission to comment on Canadian Securities Administrators ("**CSA**") Staff Notices 91-303 and 91-304 –*Proposed Model Provincial Rule on Mandatory Central Clearing of Derivatives* and *Model Provincial Rule – Derivatives: Customer Clearing Protection of Customer Collateral and Positions* ("**Model Rules 91-303 and 91-304**" or the "**Model Rules**"). The Model Rules were published by the CSA Derivatives Committee (the "**Committee**"), on December 19, 2013, and January 16, 2014 respectively, to provide interim guidance and solicit public comments regarding the CSA's proposed rules in relation to mandatory clearing of derivatives and derivatives clearing agencies.

Capital Power generally supports the efforts of the CSA to establish a regulatory regime for the Canadian over-the-counter ("**OTC**") derivatives market as required by Canada's G-20 commitments. Capital Power appreciates the opportunity to comment on the Model Rules and we applaud the Committee's effort in

seeking to develop OTC derivatives regulation that would "strike a balance between proposing regulation that does not unduly burden market participants in the derivatives market, while at the same time addressing the need to introduce effective regulatory oversight of derivatives and derivatives market activities".

Capital Power is a growth-oriented North American power producer headquartered in Edmonton, Alberta. Capital Power owns more than 2600MW of power generation capacity at 14 facilities in Canada and the United States and owns 371MW of capacity through power purchase agreements. An additional 490MW of owned generation capacity is currently under construction in Alberta and Ontario. Capital Power operates and optimizes power generation from a variety of fuel sources including coal, natural gas, bio-waste and wind. In Alberta, Capital Power's portfolio, including interests in joint venture facilities, comprises approximately 1000MW of merchant generation capacity. Assuming an Alberta electricity pool price of $60/MWh, Capital Power's Alberta portfolio represents an annual notional value of approximately half a billion dollars for which the commodity price exposure is actively managed and optimized.

Capital Power optimizes and hedges its portfolio using physical forward contracts for electricity, natural gas, environmental commodities and USD/CDN currency exchange, and financial derivative transactions based on those same commodities. Capital Power's trading counterparties include other independent power producers, utility companies, banks, hedge funds and other energy industry market participants. Trading activities take place through electronic exchanges, such as ICE (Intercontinental Exchange) and NGX (Natural Gas Exchange), brokered transactions and directly with counterparties.

SPECIFIC COMMENTS:

Capital Power has the following specific substantive comments regarding the Model Rules:

CSA Staff Notice 91-303- *Proposed Model Provincial Rule on Mandatory Central Clearing of Derivatives* ("Model Rule 91-303")

1. **Definitions and Interpretations**

Part of the definition of a '*financial entity*', in Section 1(f) of Model Rule 91-303, includes "*a person or company subject to a registration requirement, registered or exempted, under the securities legislation of a jurisdiction of Canada*". Until CSA Consultation Paper 91-407 Derivatives: Registration (the "**Registration Paper**") becomes finalized into at least a model provincial registration rule it will be practically impossible for derivatives market participants to determine whether they may have to register under securities legislation because of their derivatives trading activity. Accordingly, unless or until the registration requirements are fully clarified it will be practically impossible for derivatives market participants to determine if they would fall under the "*financial entity*" definition in Section 1(f) of Model Rule 91-303. Capital Power urges the Committee to provide guidance about how derivatives market participants are supposed to interpret the Section 1(f) definition of "*financial entity*" until the Registration Paper takes more final form. Alternatively, Capital Power urges the CSA to delay implementation of the proposed mandatory clearing regime until registration requirements have been fully clarified and implemented.

Capital Power recommends that the Committee clarify and expand the criteria that it has listed as satisfying the concept of "hedging or mitigating commercial risk", in Section 3(a) of Model Rule 91-303. In

Capital Power's experience, the current list represents what in industry parlance would be called an "economic" or "commercial hedge". Capital Power recommends, firstly, that the term "economic/commercial hedge" be included as a definition in Model Rule 91-303 to describe the criteria currently listed in Section 3(a). Secondly, Capital Power recommends that an additional, **alternative** definition of "hedging" be included under which hedging includes any transaction that meets the requirements to be accounted as hedges under IFRS or GAAP accounting standards. As part of these new and alternative definitions the Committee should clarify that "economic/commercial hedges" which satisfy the criteria listed in Section 3(a) meet the definition of being "held for the purpose of hedging or mitigating commercial risk" irrespective of whether they meet the requirements to be, or actually are, accounted as hedges under the relevant account standard. That clarification is important because although all IFRS or GAAP accounted hedges are also "economic/commercial hedges", all "economic/commercial hedges" do not necessarily qualify as IFRS or GAAP accounted hedges, or may not be actually accounted as such by the entity accounting for them.

In the interests of international regulatory consistency, it is important that the Committee makes these criteria (hedge accounting according to IFRS or GAAP or economic/commercial hedging) alternatives to each other and provides that both criteria satisfy the "hedging or mitigating commercial risk" test under Model Rule 91-303. This two-pronged, alternative approach would be consistent with the approaches taken by both the United States Commodity Futures Trading Commission ("**CFTC**") and the European Market Infrastructure Regulation ("**EMIR**") for their respective hedging definitions in the context of end-user exemptions to mandatory clearing. In the CFTC's Final Rule for the end-user exception from mandatory clearing, the CFTC revised § 39.6(c)(1)(iii) in its Regulations to include swaps that qualify for hedging treatment under the US Financial and Governmental Accounting Standards. In the EMIR regulatory technical standards, the European Commission defined the hedging exemption to mandatory clearing to include a derivative that "qualifies as a hedging contract pursuant to IFRS adopted in accordance with Article 3 of Regulation (EC) N0 1606/2002".

In addition, Capital Power recommends that the Committee provide the same clarifications as those provided by the CFTC and the European Commission regarding the hedging exemption, namely:

- That the hedge accounting definition may be relied upon by counterparties regardless of whether or not they themselves apply IFRS rules. In this regard we note that the European securities Market Authority has stated that:

  > *"...for those non-financial counterparties that use local accounting rules, most of the contracts classified as hedging under such local accounting rules would fall within the general definition of contracts reducing risks directly related to commercial activity or treasury financing activity provided for* [in the first clause of the EMIR hedging definition]".

- That both "proxy hedging trades" (i.e. where a non-financial entity counterparty uses a closely correlated instrument to hedge a particular risk because there is no directly related instrument available) and "portfolio hedging" (i.e. where a single entity in a non-financial entity corporate family enters into trades to offset risks of other entities in the corporate family) can be considered as hedging for the purposes of the Model Rule 91-303, as is the case under EMIR and the CFTC's end-user exception.

- That where a non-financial entity counterparty seeks to reduce exposure under an existing trade by entering into an offsetting trade, the offsetting trade can also be considered as hedging activity, as is the case under EMIR.

- That the Committee add and apply an "economically appropriate" standard, as the CFTC has done, in addition to the hedging factors already listed in the Model Rule to help end-users distinguish between those derivatives that hedge or mitigate commercial risks, or are done for treasury financing purposes, from those that do not. As the CFTC and the European Union have done, the Committee should adopt a flexible approach to the definition of "hedging or mitigating commercial risk", given the wide varieties of derivatives, potential end-users, and hedging strategies to which the Model Rule will apply.

Capital Power also recommends that the Committee define the term "closely correlated" as used in Section 3(a) of Model Rule 91-303. The Explanatory Guidance with respect to Section 3(a) uses the terms "closely correlated" or "highly effective" but does not define either term. Capital Power asks the Committee to either specifically define these terms or to at least provide further guidance about how it would interpret those terms.

Under IFRS those terms would have specific definitions, which in the case of "highly effective" qualify (but do not mandate) a transaction to be designated for hedge accounting. However, as stated above, not all economic/commercial hedges entered into by an end-user would be "hedged" from an IFRS or GAAP accounting perspective. As such, the economic/commercial hedges would not be assessed or documented for their correlation or effectiveness the same way that accounting hedged transactions would be, if at all. To clarify how the Committee would require entities to assess or document their hedging effectiveness, Capital Power requests that the Committee provide further clarifications, including the following:

- Concerning the form and substance of hedging effectiveness supporting documentation. The last paragraph of the Explanatory Guidance for Section 3 speaks to such supporting documentation. The list of what should be included in supporting documentation is very similar to the requirements for hedge accounting. However, if an end-user does not apply hedge accounting to all of its hedging derivatives, then what form and substance of supporting documentation would be required for economic/commercial hedges?

- Demonstrating hedge effectiveness on a transaction by transaction basis would be an extremely onerous compliance burden. Capital Power therefore asks that the Committee consider allowing effectiveness to be demonstrated on a portfolio-wide basis and regardless of whether certain of an end-user's derivatives are afforded hedge account treatment while other derivatives are not, as long as all of the derivatives are intended to mitigate risks.

- What the consequences would be if, in any period, an entity failed to demonstrate hedging effectiveness either on a transaction by transaction or a portfolio-wide basis? If an entity assesses hedging effectiveness on a portfolio-wide basis, and such effectiveness could not be demonstrated to the satisfaction of the relevant securities commission, would that mean that the entire portfolio of derivatives would have to be cleared going forward, even though effectiveness of specific transactions could be demonstrated in isolation? If the entity assesses effectiveness on a transaction by transaction basis, and the hedging effectiveness of specific transactions could

not be demonstrated, would this mean that those transactions would suddenly need to be centrally cleared perhaps many months after they had been entered into?

Capital Power also recommends that the Committee define or clarify the term "*speculation*" used in Section 3(b)(i), either in Section 1 or in the Explanatory Guidance to Model Rule 91-303. In this regard, the Committee should clarify and interpret the distinction between speculative and hedge/mitigation transactions to clarify the following:

- From a practical perspective, would the Committee base the distinction between a speculative or hedge transaction on how an entity's front and middle offices classify and distinguish trades for deal entry and documentation purposes?

- 'Speculation' is sometimes defined as transactions having the purpose of generating short term profit from market changes. Capital Power believes that definition is overly simplistic and fails to recognize the commercial reality that all reasonable business transactions, whether derivatives or not, are entered into with the anticipation that they will either generate profit or mitigate losses for the business. Capital Power strongly urges the Committee not to adopt this definition, or at least not without further clarification. Instead, Capital Power urges the Committee to define 'speculation' as being to the exclusion of any 'economically appropriate' standards (referred to above) for hedging or mitigating commercial risk.

2. Substituted Compliance

Capital Power requests that the Committee clarify how it will implement substituted compliance, as provided for in Section 4(2), given that different provinces are at different stages of development with respect to proposed model rules and the regulatory infrastructure to oversee mandatory clearing of derivatives, if and when the CSA mandates that certain asset classes of derivatives must be cleared?

To give an example, if an Alberta domiciled counterparty is an Ontario "local counterparty" only because it is a guaranteed affiliate of an Ontario entity, that counterparty may satisfy the Ontario clearing requirement by submitting a transaction for clearing to a clearing agency in another Canadian Province, or a foreign jurisdiction [to be] listed in Appendix B. In that example, how is substituted compliance to work if the other Canadian province has not yet finalized its clearing rules but has exempted the clearing agency because it is recognized in a foreign jurisdiction? In other words, until the Alberta Securities Commission, for example, has implemented a clearing requirement and has recognized or exempted central clearing agencies operating in Alberta, would the Ontario guaranteed-affiliate local counterparty be required to clear transactions in Ontario? After an Alberta clearing regime is in place, would the same Ontario guaranteed-affiliate local counterparty cease clearing transactions in Ontario and start clearing them in Alberta? What if the clearing requirements aren't the same between Alberta and Ontario in terms of asset classes of derivatives that are designated for mandatory clearing? Which Province's requirements would govern? The same questions apply in the context of non-Canadian foreign jurisdictions under the substituted compliance concept in Section 4(2)(b)(ii).

3. Record-Keeping-Section 10

Capital Power notes that in the Explanatory Guidance with respect to Sec. 10, the Committee appears to assume that a derivatives market participant already keeps detailed quantitative and qualitative records concerning its "*macro, proxy or portfolio hedging strategy or program"* and performs regular audits "*to ensure that the strategy or program continues to be used for relevant hedging purposes*". As stated earlier, Capital Power infers that the Committee is suggesting a requirement for supporting documentation that is very similar to those required by hedge accounting under IFRS. Capital Power strongly urges the Committee to clarify whether such hedge-accounting compliant record-keeping is a true requirement for all hedging derivatives under Model Rule 91-303 or simply a recommendation? If it is only a recommendation, then with respect to economic/commercial hedges to which an entity does not apply hedge accounting treatment, what hedge effectiveness documentation and record-keeping would the Committee expect and accept?

The Explanatory Guidance with respect to Section 10 also speaks to keeping records of approvals by boards of directors, or similar bodies, of the "*..business plan or strategy which authorizes management to use derivatives as a risk management tool...*". Capital Power submits that evidence of board approval should be with respect to general corporate governance "policies" that allow for the use of derivatives, rather than "business plans" or "strategies". Capital Power suggests that the important distinction between these terms is that "policies" form part of fundamental corporate governance, are relatively stable over time and justifiably require the attention of boards of directors. By contrast, "business plans" or "strategies" may be opportunistic, highly variable over relatively short time periods and do not typically rise to the attention of boards of directors. Evidence of board approval of a corporate policy that allows for the use of derivatives for risk management should be enough for the purposes of Model Rule 91-303.

4. Crown Corporations Exemption-Section 11

Section 11 of Model Rule 91-303 provides for an exemption from the clearing requirement for Crown corporations or entities whose obligations are guaranteed by the federal or provincial governments. Capital Power submits that this exemption would give such entities, to the extent they participate in derivatives markets, a competitive advantage over "non-Crown" entities that will be required to comply with the clearing mandate. The clearing compliance requirement will likely result in additional costs compared to transacting derivatives over-the-counter. Non-Crown entities will have to incur these additional costs while Crown corporations will avoid them, thereby giving Crown corporations a competitive cost advantage. Based on Capital Power's market experience several Crown corporations are active and sophisticated derivatives market participants. To better ensure transparency and a "level playing field" in derivatives markets Capital Power submits that all derivatives market end-users should be subject to the same requirements with respect to mandatory clearing, or exemptions from it, and special treatment should not be afforded to one particular class of end-user to the potential detriment of other end-users.

5. Clearing of Pre-Existing Transactions and Section 16-Transition

Section 16 provides that derivative transactions that existed before the coming into force of the Model Rule will not need to be cleared *unless there is a material amendment, novation, or assignment, sale, etc.* of the trade (a "**Material Change**") after coming into force of the Rule. The Explanatory Guidance explains that this was a compromise position from the original intention of the Committee that all pre-existing transactions, in effect at the time the Rule comes into force, should be subject to mandatory clearing.

Capital Power submits that the compromise is still problematic because requiring mandatory clearing of a transaction that two counterparties entered into without considering the impact of mandatory clearing, even if only triggered by a Material Change, will still place new and unanticipated compliance burdens on the two counterparties and potentially impact the underlying economics of the transaction.

Capital Power contends that, in terms of compliance burdens, the counterparties will undoubtedly have to amend the terms of their contractual arrangements to address the new clearing requirement that was triggered by a Material Change. They may have to enter into new contractual relationships with clearing agency members that they may not otherwise have to do but for Section 16. Collateral arrangements between the two counterparties will have to be unwound and replaced with collateral arrangements between each counterparty and the clearing agency member. Finally, because the original transaction was entered into bilaterally, without contemplating that it might become subject to mandatory clearing, the economic fundamentals of the transaction would not have addressed the transaction and collateral costs associated with clearing. The new clearing requirement could very well make the pre-existing transaction uneconomic.

Capital Power requests that the Committee provide clarity and revise Section 16 to confirm that the end-user and intragroup exemption provisions in Sections 7 & 8 will apply to Material Changes. In other words, Material Changes of pre-existing transactions, which would otherwise qualify for the end-user or intragroup exemptions, should not make the pre-existing transaction subject to the clearing requirement only because of the Material Change.

CSA Staff Notice 91-304- *Model Provincial Rule – Derivatives: Customer Clearing Protection of Customer Collateral and Positions* ("Model Rule-91-304")

1. **<u>The Definition of "Permitted Investment"</u>**

Capital Power recommends that the Committee change the definition of "*permitted investment*" in Section 1(1) of Model Rule 91-304 as follows [suggested change in **bold**]:

- "permitted investment" means cash or highly liquid financial instruments with minimal market and credit risk that are capable of being liquidated rapidly with minimal adverse price effect ***and that have a minimum rating of A- by S&P, A(low) by DBRS, or A3 by Moody's***. [Corresponding definitions of each of DBRS, S&P and Moody's will also have to be added.]

Capital Power also recommends that in conjunction with the definitional change above, an addition to Section 23(1) would include keeping records with respect to the credit ratings associated with "permitted investments". For example, a new Section 23(1)(h) could read as follows:

- (h) the current credit ratings associated with the investments.

Capital Power respectfully requests that the Committee consider its comments. Capital Power looks forward to further consultation papers and model rules prior to the creation of legislation and regulations to govern the Canadian OTC derivatives markets. If you have any questions, or if we may be of further assistance, please contact the undersigned at 403-717-4622 or (znagy-kovacs@capitalpower.com).

Yours Truly,

"***CAPITAL POWER***"

Per: _____

Zoltan Nagy-Kovacs
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