



Testimony of

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ON BEHALF OF

THE AMERICAN PUBLIC POWER ASSOCIATION (APPA)

For the

HOUSE ENERGY AND COMMERCE COMMITTEE'S SUBCOMMITTEE ON

ENERGY AND ENVIRONMENT

Hearing on "Impacts of H.R. 3795, the Over-the-Counter Derivatives Market Act of 2009,

on Energy Markets"

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I appreciate the opportunity to provide the following testimony for the House Energy and Commerce Subcommittee on Energy and Environment's hearing on "Impacts of H.R. 3795, the Over-the-Counter Derivatives Markets Act of 2009, on Energy Markets."

I am Patrick McCullar, President and CEO of Delaware Municipal Electric Corporation (DEMEC). DEMEC is a public corporation constituted as a Joint Action Agency and a wholesale electric utility. DEMEC represents nine municipal electric distribution utilities located in the State of Delaware. DEMEC is a Load Serving Entity and a Generation Owner in the PJM Regional Transmission Organization serving 13 states and the District of Columbia. The

continued goal and mission of DEMEC is to advance the principles of public power community ownership and provide competitive, reliable energy supply and services to our member's stakeholders and customers. DEMEC is able to accomplish its mission through active representation and participation in regional and federal arenas. DEMEC and its member municipal electric utilities have provided competitive, reliable electric service for decades, and will continue to provide the best service at the lowest possible cost for the ultimate benefit of the consumers and communities we serve.

Today I am testifying on behalf of the American Public Power Association. APPA represents the interests of more than 2,000 publicly-owned electric utility systems across the country, serving approximately 45 million Americans. APPA member utilities include state public power agencies and municipal electric utilities that serve some of the nation's largest cities. However, the vast majority of these publicly-owned electric utilities serve small and medium-sized communities in 49 states, all but Hawaii. In fact, 70 percent of our member systems serve communities with populations of 10,000 people or less.

Overall, public power systems' primary purpose is to provide reliable, efficient service to their local customers at the lowest possible cost, consistent with good environmental stewardship. Like hospitals, public schools, police and fire departments, and publicly-owned water and waste-water utilities, public power systems are locally created governmental institutions that address a basic community need: they operate on a not-for-profit basis to provide an essential public service, reliably and efficiently, at a reasonable price.

Support for Greater Transparency in Energy Markets

Unfortunately, volatility in the price of energy supply such as natural gas and electricity can make it difficult for public power systems to consistently provide electric service to their end-use customers at reasonable prices. While energy markets suffer from volatility for many reasons, including storage capacity, weather and economics, in recent years, the price of energy commodities has not been determined solely by these traditional variables. Manipulation and speculation for profit in energy markets has caused artificially high prices. APPA has therefore consistently supported increased transparency in these markets. In 2007, the APPA Membership passed a resolution in support of increased transparency in over-the-counter (OTC) natural gas markets. Earlier this year APPA members passed another resolution in support of increased transparency and regulation in OTC energy fuels markets.

Regulation of Financial Transmission Rights

Because of these strong concerns with market manipulation, APPA recognizes that the Commodity Futures Trading Commission (CFTC) can play a beneficial role in policing and preventing manipulation in energy markets. The CFTC and the Federal Energy Regulatory Commission (FERC) could be most effective when working together to stop and prevent manipulation in energy markets run by Regional Transmission Organizations (RTOs). However, we also would urge Congress to use caution when drafting legislation, to avoid creating duplicative authorities between CFTC and FERC over all other aspects of power supply and transmission markets that are run by RTOs or Independent System Operators (ISOs).

There are currently six RTOs/ISOs in the country under the jurisdiction of FERC. In regions with operating RTOs/ISOs, market participants buy and sell a variety of electricity products and services in the centralized markets these RTOs/ISOs administer. These power supply-related products and services are typically not furnished by the RTO itself; instead they are sold by market participants through centralized, auction-type market structures that the RTO administers. For example, most RTOs/ISOs operate “day-ahead” and “real-time” markets through which market participants buy and sell wholesale electric power. RTOs also administer markets for the purchase and sale of financial transmission rights (FTRs), which APPA members and other Load Serving Entities (LSEs) use to hedge the costs of transmission congestion associated with the transmission service they purchase from the RTOs/ISOs to move their power supplies to their retail customers (loads).

While these FTRs are financial contracts, their terms, conditions and rates are comprehensively regulated by FERC and they should remain under FERC jurisdiction. These FTRs took the place of the physical transmission rights that LSEs had used to serve their loads prior to the implementation of RTO/ISO power supply markets. The ability of LSEs to have continued access to FTRs on reasonable terms and conditions is absolutely essential to their ability to serve their retail loads at reasonable rates and with less price volatility.

RTO market rules are fully regulated by FERC and are set out in FERC-approved tariffs. The rates, terms and conditions applicable to any RTO product under a FERC tariff should not be subject to concurrent jurisdiction by CFTC. Concurrent jurisdiction could result in inconsistent

regulations and uncertainty over enforceability of transactions. Because of this concern, if concurrent jurisdiction is found, CFTC should be required to consult with FERC regarding these markets and should be given statutory authority to cede jurisdiction to FERC.

However, as previously mentioned, APPA recognizes that CFTC has played a beneficial role in policing and preventing manipulation of prices in energy markets. APPA would therefore support concurrent FERC and CFTC jurisdiction over market manipulation in RTO-administered markets. APPA would urge the two agencies to pool their resources and expertise to provide more comprehensive oversight in this specific area.

Mandatory Clearing

Because of the volatility of energy markets, many public power systems use OTC derivatives to hedge the prices of natural gas and electricity that they obtain to serve their end-use customers. Because of their high credit ratings, ensured ratepayer revenue and substantial investment in utility infrastructure, many public power systems do not currently have to pledge liquid collateral for transactions below certain agreed upon dollar levels.

Some proposed legislation would require all OTC derivatives transactions to be cleared. This would require many public power systems to start posting margin for all of their OTC transactions, and require them to have collateral on hand to meet potential margin calls when required.

Requiring public power systems to comply with such requirements for all of their OTC transactions would be cost-prohibitive and would directly raise the price of electricity to their end-use consumers. Rates would increase because of the direct costs associated with clearing—this would include the cost of the required margin needed for each transaction, the cost of the margin the public power system would need to have on hand at any given time, and the increased borrowing costs incurred should the system still use the market to hedge. If a public power system chose not to continue using the OTC market to hedge its transactions because of the costs associated with these requirements, prices would still increase for consumers. This is because the public power system would be exposed to increased price volatility in electricity and natural gas markets, and, as non-profit entities, would have to pass unhedged price increases through to end-use consumers in its retail rates.

Some proposals would allow entities to meet clearing requirements using non-cash collateral. This option, however, generally is not viable for public power utilities. Many of these systems are prohibited by their constitutional documents and/or bond covenants from pledging their assets in such a manner. They would therefore be required to pledge non-cash collateral in the form of liquid assets. Public power utilities do not maintain the kind of liquid assets that would be required to support a transactional requirement.

But more important, mandatory clearing would effectively eliminate the current practice by some public power entities of using tax-exempt financing for the prepayment of long-term natural gas and electricity supply contracts, also known as “prepays.” The Energy Policy Act of 2005 endorsed pre-pays by making some clarifications and creating a safe-haven for users of pre-pays

should they have unforeseen circumstances such as the loss of a large customer. Since that time, pre-pays have been an extremely important financing tool for public power systems. These contracts allow public power systems to firm up natural gas and electric power supplies for up to 30 years into the future. One critical component of such prepay agreements is an OTC swap transaction that allows the public power system to pay a discounted rate below the prevailing spot market price for the commodity. The OTC derivatives used in prepays are “tear up” agreements; that is, they terminate at no cost in the event the prepay terminates. Due to the size and very long-term nature of a prepay, requiring clearing of a prepay swap would be so cost prohibitive that public power systems would no longer be able to use this important tool. This would increase the exposure of retail customers served by such public power systems to price volatility and, consequently, higher end-use customer costs.

APPA supports the clearing language in H.R. 3795 that provides an exemption from clearing for end-users. APPA opposes legislation that requires all OTC derivatives to be cleared, regardless of the nature of the end-user counter-party. Requiring public power systems to clear would pose significant financial hardships to them and the local governments that own them, without addressing any of the systemic problems that caused the financial crisis in which we now find ourselves. Derivatives end-users such as public power systems do not pose systemic risk to the market, as do bank-to-bank exchanges for the purposes of profit-making. Therefore, derivatives end-users should not be subject to the same type of regulation.

FTRs and buy/sell swaps offer effective risk hedging tools for the Delaware utilities because they face significant transmission cost risks related to insufficient transmission capacity and

transmission congestion in the PJM footprint. The Delaware utilities must use these hedging tools to minimize the risk of unexpected price increases in the competitive energy markets and to assure reasonable prices to our end-use consumers. Without these hedging tools, Delaware public power utilities would be exposed to additional costs of as much as 5% of total delivery costs, or \$5 million annually.

Continuing to allow energy end-users such as public power systems to use non-cleared, individually negotiated OTC transactions will be extremely important to our members in order to continue to offer the best electric rates possible to their customers.

In conclusion, while APPA fully supports legislation to curb manipulation in the OTC derivatives market, we urge Congress to use caution when drafting legislation in this area to ensure it does not have an unintended, adverse effect on retail electric and natural gas customers. From APPA's perspective, a well drafted bill will include the provisions necessary to curb market manipulation while preserving FERC's primary jurisdiction over RTO/ISO markets, including the FTR markets, and preserving the ability of energy end-users to use non-cleared OTC swaps to hedge against energy price volatility.