PREPARED STATEMENT OF

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U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON ENERGY AND COMMERCE
SUBCOMMITTEE ON ENERGY AND ENVIRONMENT

HEARING ON

"IMPACTS OF H.R. 3795, THE OVER-THE-COUNTER DERIVATIVES MARKETS ACT OF 2009, ON ENERGY MARKETS"

DECEMBER 2, 2009

Chairman Markey, Ranking Member Upton and Members of the Subcommittee:

Thank you for the opportunity to participate in today's hearing on the impacts of H.R. 3795, the Over-the-Counter Derivatives Markets Act of 2009, on energy markets.

The Electric Power Supply Association (EPSA) is the national trade association for competitive wholesale power suppliers, including generators and marketers. EPSA members include both independent power producers and the competitive wholesale generation arms of certain utility holding companies. EPSA members do business nationwide, both in the two-thirds of the country served by Regional Transmission Organizations (RTOs) or Independent System Operators (ISOs) and the remaining one-third of the country dominated by traditional vertically-integrated utilities.

The competitive power sector operates a diverse portfolio that represents 40 percent of the installed generating capacity in the United States. In many regions, such as the Northeast, Mid-Atlantic, portions of the Midwest, Texas and California, the competitive wholesale generation is over half to as much as 100 percent of the area's power supply. EPSA members use a variety of fuels and technologies to generate electricity to reliably serve consumers, including coal, geothermal steam, hydropower, natural gas, nuclear, oil, solar and wind.

EPSA joins other national energy trade associations in commending the Committee on Energy and Commerce for holding this hearing. There is no more important issue likely to be acted upon by Congress in the near future that will impact the ability of the electric power sector to operate existing plants to best serve consumers and to invest in new energy infrastructure than whether our members will continue to have access to the over-the-counter (OTC) derivatives markets on fair and reasonable terms.

As a member of the Commodity Futures Trading Commission's (CFTC) Energy and Environmental Markets Advisory Committee (EEMAC), I am well aware of and support the goals of bringing greater transparency and proper regulation to derivatives markets. EPSA supports the goals of the original Treasury Department proposal released earlier this year in terms of avoiding a repeat of the costly systemic risk posed by trading in credit default swaps and other transactions between purely financial firms.

At the same time, EPSA joins a unanimous energy end-use sector in strenuously advocating that financial regulatory reform, as it relates to derivatives, should not punish us and the consumers we serve for the actions of others who nearly brought down our financial system last year. This would occur through overly broad requirements that would essentially require energy end-user derivatives products, presently transacted on the OTC markets, be handled on an exchange and cleared through a central clearinghouse associated with the exchange.

EPSA commends the CFTC for its willingness to listen to the serious concerns expressed by energy end-users. We also greatly appreciate the changes made by the Committees on Financial Services and Agriculture to the original Treasury Department proposal that required clearing. Both committees' versions of H.R. 3795 include new exceptions to clearing which allow energy end-users engaged in OTC transactions to continue to use such markets to hedge and mitigate their exposure to commodity price fluctuations. Neither version, as reported, forces end-users to clear transactions simply because the counterparty is a large financial institution as was once considered.

However, as explained in more detail below, several critical legislative details remain to be firmly nailed down, including **(1)** definitions of key terms (e.g., major swap participant, swap dealer, swap, and substantial net position) to ensure that energy end-users' access to OTC derivatives are in fact fully protected as intended, **(2)** excluding costly and unnecessary margin requirements from being imposed on energy end-users who utilize OTC markets, and **(3)** as clear a jurisdictional line as possible is drawn between the important responsibilities of the Federal Energy Regulatory Commission (FERC), the Public Utility Commission of Texas, and the CFTC, respectively.

It is important to step back and look at the basics of electricity generation to understand why it is so critically important to the energy and environmental goals of this Committee that Congress get the regulation of OTC derivatives markets set up properly. At the most basic level, all electricity generation companies use various fuels to generate electricity. Depending on the technology, fuel represents the largest variable cost of power generation. In addition to fuel input costs, electricity generators also have to factor in the cost of any necessary emissions credits. On the output side, depending on the company and the power market, revenues from power generation are determined by market-based wholesale prices, power purchase agreement pricing terms, or cost-based rate-setting by states and others for vertically-integrated utilities.

Given the long term nature of power plant investments, and the volatility of both fuel and emissions credit input costs and wholesale power prices that determine revenues, companies engage in a variety of prudent risk management strategies to make these costs and revenues more predictable. By doing so, companies can manage cash flows by locking in some or all of these costs and revenues, which reduces costs and risks for consumers. Among other things, this permits wholesale generators to bid at competitive fixed prices to serve those states with restructured retail electricity markets in which the local electricity distribution company procures power supplies in a competitive auction to serve those consumers who do not elect an alternative retail provider. By stabilizing more predictable cash flows, these risk management practices also assist power generators in obtaining the financing necessary to maintain and expand the nation's energy infrastructure, particularly as the nation moves to de-carbonize the electricity sector.

In general terms, there are at present two types of venues to purchase the necessary risk management products: transactions through exchanges that have central clearinghouses and directly with counterparties through the OTC markets. Both venues are important and access to each is necessary for energy end-users such as power generators to best serve their customers through prudent risk management.

The primary benefit of transacting with an exchange that has a central clearinghouse is that doing so eliminates the credit risk of doing business with a specific counterparty. Instead, the exchange with the clearinghouse becomes the counterparty and guarantees performance. However, this only works well for risk management products with highly standardized terms and conditions for which there is a very liquid market composed of lots of buyers and sellers. Furthermore, the elimination of counterparty risk comes with significant attendant costs, primarily in the form of initial posting of cash collateral and potentially additional cash collateral requirements during the term of the transaction (e.g., initial and variation margin) depending on how the value of the derivative changes and in whose favor over time.

By contrast, energy end-users, such as power generating companies, use the OTC market when in need of more customized risk management products directly with specific counterparties. This customization includes both the underlying risk being hedged (such as fuel input costs or power output prices) and the collateral requirements. As to the risk being hedged, the OTC market is particularly important to power companies given that as a practical matter electricity cannot be stored so it must be generated and consumed simultaneously. Combined with the physical nature of the grid, this means that electricity must be priced and traded at hundreds of points across the country. As to collateral, the OTC market allows the parties to directly negotiate credit arrangements tailored to their circumstances.

The difference between the collateral requirements imposed by exchanges with clearinghouses and the tailored arrangements of the OTC market is at the heart of why we oppose having our risk management options limited to only those products available on exchanges with clearinghouses. The sums of cash that would be taken out of the economy and parked at clearinghouses if end-users are subject to mandatory clearing runs into the tens of billions of dollars for the power generation sector alone. Instead, this capital is needed for investments in energy infrastructure, including addressing reliability and environmental concerns.

By contrast, the OTC market permits a wider variety of collateral arrangements. In some cases, there is no collateral up to limits specifically agreed to by the parties to the transaction. In other cases, the collateral posted by energy end-users takes the form of letters of credit or liens on the power generation assets, not cash. There has been no suggestion – none at all – much less any evidence that these long-standing credit arrangements pose any systemic risk to the U.S. financial system. Accordingly, while requiring exchange trading and clearinghouses may make sense for transactions between financial firms, particularly for non-physical products such as credit default swaps that dwarf the value of energy derivatives, doing so is not appropriate when one of the parties to the transaction is an end-user, such as a power generation company.

We are pleased that at a conceptual level at least there is growing recognition of the importance of maintaining maximum risk management flexibility for all end-users. We are encouraged by statements made by CFTC Chairman Gensler that end-users should be able to continue to post non-cash collateral and that the goal of transparency in the OTC markets is not dependent on clearing. We agree.

In the final analysis, the legislative details of whatever is finally enacted into law matter the most. Accordingly, we make the following recommendations to Congress:

- The desired increased transparency in OTC markets we fully support is best achieved through greater reporting requirements, including a central data repository for all OTC transactions. H.R. 3795 includes such requirements.

- Energy end-users should not be subject to the requirements for central clearing inspired by unrelated abuses by others. H.R. 3795 imposes clearing on "swap dealers" and "major swap participants" making the precise definitions of these terms critical. As noted earlier, the Financial Services and Agriculture Committees made major strides by not adopting the broader clearing requirements in the original Treasury Department proposal.

However, under H.R. 3795, the definitions of "swap dealer" and "major swap participant" are subject to interpretation. We support a brighter line that clearly and unambiguously excludes end-users who primarily use derivatives for hedging, managing or mitigating commercial risk regardless of the counterparty.

- The definition of "swap," to which the clearing requirement would apply, should not include financially-settled physical transactions known as book-outs, consistent with long-standing CFTC treatment of these forward transactions.

- The definition of "swap" should expressly not include the day-ahead, real-time and financial transmission rights products in RTOs and ISOs. These markets are independently administered by the RTOs and ISOs under detailed FERC-approved tariffs (or tariffs approved by the Public Utility Commission of Texas for ERCOT) and subject to multiple layers of oversight including by independent market monitors. FERC should have plenary and exclusive jurisdiction over RTO/ISO products. There has been no showing as to why they should be separately regulated by the CFTC in addition to the existing multiple layers of oversight. At present, H.R. 3795 does not address this key jurisdictional issue. We strongly urge that Congress address it in H.R. 3795.

- Any speculative position limits should be set by the CFTC with a directive to maintain sufficient liquidity for legitimate end-user hedging transactions.

- The determination of which products are accepted for central clearing on an exchange (as opposed to remaining on the OTC market) should be made by federal regulators, not by the exchanges. Some versions of the legislation leave this decision to the clearinghouses that would benefit from finding a product clearable. This issue continues to appear somewhat unsettled in light of discussions following the committee markups of H.R. 3795.

- Margin requirements should not apply to OTC transactions for the same reasons that clearing should not be required. The Financial Services Committee version of H.R. 3795 would permit the CFTC to apply such margin requirements, which would defeat the exclusion from mandatory clearing. The Agriculture Committee version wisely does not include such a provision.

- The changes made by the new law should be prospective and clearly not apply to any derivatives transactions entered into prior to enactment.

Thank you for the opportunity to present these views and recommendations on these important issues, on behalf of competitive electricity suppliers and our customers. We look forward to working with all relevant Congressional committees, along with federal regulatory agencies, to strike the proper balance between greater financial transparency and maintaining access to necessary energy risk management products on fair and reasonable terms. Doing so will allow us to best serve our customers while investing tens of billions of dollars in new, cleaner energy infrastructure.