

**Statement on Proposed Reform of
Over-the-Counter Derivatives Markets**
**Submitted to House Financial Services Committee Chairman Barney Frank
by the Coalition of Energy Derivatives End-users**
October 7, 2009

The associations noted¹ represent the electric power and natural gas industries serving every energy consumer in the United States. We use over-the-counter (OTC) derivatives extensively to manage commodity price risk for electric power, natural gas and other fuels, as well as to contain risk related costs when financing energy infrastructure. OTC contracts help to insulate our customers from excessive price volatility and help keep electric rates paid by consumers stable and affordable. It is also important to note that these transactions are not the source of systemic risk to the broader economy.

We appreciate the opportunity to submit this statement on the reforms being considered by the House Financial Services Committee to the OTC derivatives markets. These associations support the goals of the Administration and the Congress to increase regulation as well as improve transparency and stability in OTC derivatives markets. When discussing any increased regulation of exchange and OTC markets, we believe there should be an appropriate balance between establishing market oversight rules that allow for a broad use of market-based risk management tools while providing regulators with the ability to establish a high level of transparency and the tools needed to protect consumers against market manipulation and systemic risk.

We believe that reform to the OTC derivatives markets should increase transparency and oversight to provide confidence to market participants and consumers in the fairness of these markets. In our view, effective OTC derivatives reform should:

- Promote greater regulatory oversight and transparency of OTC derivatives through increased financial reporting and authority to the Commodity Futures Trading Commission (CFTC) to prevent manipulation of the derivatives markets.
- Promote clearing of standardized derivatives or large financial dealers, where appropriate, through regulated central counterparties to reduce systemic risk and bring additional transparency through information regarding pricing, volume and risk.
- Promote the harmonization and clear delineation of regulatory authorities and functions among the Securities and Exchange Commission (SEC), the CFTC, the Federal Energy Regulatory Commission (FERC) and other Federal agencies to

¹ America's Natural Gas Alliance, American Exploration and Production Council, American Gas Association, American Public Gas Association, American Public Power Association, Edison Electric Institute, Electric Power Supply Association, Independent Petroleum Association of America, Interstate Natural Gas Supply Association, Large Public Power Council, National Rural Electric Cooperative Association, Natural Gas Supply Association, and U.S. Oil & Gas Association.

ensure similar products are governed by similar standards. Accordingly, such harmonization should also work to minimize the burden and cost of compliance with regulatory oversight.

These joint associations, however, are concerned with certain aspects of proposals to address oversight of OTC energy markets. Most notably, we oppose mandates that all derivatives transactions be centrally cleared or executed on exchanges. Such a requirement would greatly reduce the ability of companies to find the customized derivative products they need to manage their risks because clearinghouses and exchanges require a high level of margin and collateral for the derivatives and commodities products traded. Such customization is necessary for everything from specific delivery points in electricity contracts to quantities of natural gas. Without the ability to use these customized transactions energy suppliers would be severely constrained in types of products and the costs of those products that could be offered to consumers.

While centrally cleared exchanges strictly require cash collateral, individually-negotiated OTC contracts allow hedging entities to use alternative collateral structures such as asset liens, credit lines or no collateral below agreed upon thresholds. In some cases, because of the very high credit worthiness of a hedging entity there will be a reasonable threshold that must be reached before collateral would have to be posted. Providing such flexibility frees up scarce capital for investments in new energy infrastructure. Conversely, not allowing such collateral structures and forcing all OTC transactions to clear through exchanges would unnecessarily divert substantial capital from productive investments and drive up the price of energy commodities.

In addition, for centrally cleared products to be effective, standardization and a critical mass of market participants to facilitate a robust market are key. For example, in the case of electricity, since its unique physical nature precludes significant storage and requires that it be consumed when generated in hundreds of physical markets, the prerequisites for standardized and centralized clearing are missing. So, electricity price risk cannot be managed through a selection of exchange-traded contracts. Rather, such derivatives often require customization in order to be effective.

Limiting access to these risk management tools by mandating the clearing of OTC transactions would jeopardize the ability of energy providers to manage risks, increase consumers costs and increase excessive consumer exposure to market volatility. The OTC markets' very purpose is to provide customized solutions that meet the individual needs of customers with flexible products as well as diversified margin and collateral requirements.

Provisions requiring clearing of transactions will only increase costs and limit market participants' ability to manage risks without creating any offsetting benefits. As a primary example, utilities purchase firm supplies in the physical delivery market at prevailing market prices, and enter into OTC derivative agreements customized to meet their specific needs, reduce their consumers' exposure to future market price fluctuations and stabilize rates.

Similarly, electricity suppliers use OTC forward contracts to plan for and commit to future electric power needs when they do not own sufficient generation assets to meet the total electric demand in their distribution service territories. These suppliers employ various tools to shield customers from potential price volatility in wholesale electric markets, and the availability of OTC contracts allows them to (1) avoid higher costs from the cash margin requirements of a clearinghouse or exchange and (2) secure true hedges of the prices of wholesale purchased power at hundreds of delivery points.²

Simply put, electricity and gas providers have a legitimate need to engage in bona fide risk management in the OTC markets. The overly broad imposition of mandatory clearing requirements would impose large and untenable cost increases on businesses and consumers, and severely limit the product and service offerings companies can provide to energy consumers. In addition, we are concerned that excessively restricting what entities could participate in the OTC markets could have the unintended consequence of eliminating the very counterparties used by commodity suppliers.

Additionally, while competitive financial markets provide the best risk management tools, should speculative position limits nevertheless be mandated, we encourage Congress to allow the CFTC to set such limits in a reasonable manner that would ensure the necessary liquidity in a robust marketplace for bona fide risk management transactions. Any aggregate speculative positions should not impair bona fide risk management transactions such as those our members rely on.

This group of energy associations would also like to acknowledge the constructive and thoughtful discussion draft put forward by Chairman Frank, which reflects a number of the concerns that we have raised to date. We particularly appreciate the draft bill's recognition of the importance of maintaining the OTC markets for risk management purposes. We stand ready to work with you to craft reforms that enhance transparency and improve overall market functions without creating unintended adverse consequences for us and the consumers we serve.

Thank you for your consideration of our views on this important topic.

² Additionally, in many jurisdictions with restructured retail electricity markets, regulated utilities have provider of last resort obligations, requiring them to be prepared to provide service to retail customers that have chosen an alternate supplier if those customers suddenly find themselves without service from their alternate supplier (for example, an alternate retail supplier might cease operations and return its customers to the incumbent utility). Regulated utilities will similarly use OTC products to hedge against the possibility that it will need to provide service to many of these customers, and ensure that these customers continue to be served reliably at reasonable rates.