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On behalf of the end-user coalition

Before the Committee on Agriculture

United States House of Representatives

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Good Morning, Chairman Lucas, Ranking Member Peterson, Members of the Committee, it is a pleasure to appear before you this morning. My name is Brenda Boultwood and I serve as Chief Risk Officer and Senior Vice President for Constellation Energy. I am here today in my capacity as an officer with Constellation; but, I am also here representing the broader end-user coalition, which is comprised of a variety of entities from agricultural interests, to manufacturers, car companies, airlines, and energy companies. While it may seem odd to have such a diverse and broad coalition coalescing around the same set of legislative proposals, I want to assure the Committee that we appreciate your hard work in helping to address some of the unintended consequences of the Dodd-Frank Act, as well as some of the broadly interpreted proposed rules that we believe go well beyond Congressional intent. Let me be clear from the outset, our coalition is not opposed to greater transparency in these markets. In fact, we are highly supportive of greater transparency. But, you achieve transparency through reporting, not classifying end-users as swap dealers. Simply put, end-users do not create systemic risk and none in our coalition were behind the collapse of the economy in 2008. Therefore, we are here today to offer our thoughts to several legislative proposals that we believe will help resolve those unintended consequences.

Before I begin my testimony on the proposed legislation, I would like to give a brief background about myself, who Constellation is, and how and why we use derivatives to help manage our customer's risk.

I have been involved in risk management practices in a variety of capacities – academia, commercial entities, financial institutions, and consulting - for more than thirty years. I serve on the Boards of the Committee of Chief Risk Officers (CCRO) and the Global Association of Risk Professionals (GARP), as well as serving as a member of the CFTC's Technology Advisory Committee. As you may recall, the CCRO began as a result of the accounting scandals from the early part of the last decade and is comprised of CRO's across the entire energy spectrum.

Constellation Energy is a Fortune 200 company located in Baltimore, MD, and is the largest competitive supplier of electricity in the country. We serve more than 30,000 megawatts of electricity daily and own approximately 12,000 megawatts of generation that comes from a

diversified fleet across the U.S. To put that in perspective, our load obligation is approximately the same amount of power consumed by all of New England on a daily basis. We serve load to approximately 36,000 commercial and industrial customers in 36 states and we provide natural gas and energy products and services for homes and businesses across the country. Finally, the company delivers electricity and natural gas through the Baltimore Gas and Electric Company (BGE), our regulated utility in Central Maryland.

One of the reasons we have been so successful in growing our competitive supply business is due in large part to our ability to win load serving auctions by being the low cost provider. We are able to be the low cost provider due to a variety of risk management tools we employ to the benefit of our customers. We utilize exchange trading, clearinghouses and over-the-counter (OTC) derivatives to help manage these risks.

For example, electricity – it must be produced and consumed simultaneously; cannot be stored; and has some very volatile fuel exposure – coal, natural gas, and uranium. Furthermore, electricity gets delivered to thousands of points along the grid at a moment's notice. Physical energy markets are volatile and unpredictable, but hedging with derivatives allows Constellation to manage these risks and provide its thousands of customers with electricity and natural gas at a low fixed price.

Now, I would like to specifically address some of the proposed pieces of legislation that will help to resolve some of the unintended consequences that are emanating from the Commodity Futures Trading Commission's (CFTC) proposed rules.

For instance, H.R. 2682 is a bill that focuses on margin requirements for end-users. Today, an end-user decides whether to execute a derivative hedge through an exchange or over-the-counter (OTC). If it is conducted through an exchange, initial margin is posted and variation margin is required or returned depending on price fluctuations. If we transact OTC, we may utilize unsecured lines with counterparties and post margin when exposures exceeds the size of a credit line. In other words, we navigate between liquidity risk, or posting margin, and counterparty credit risk. Today, this credit risk can be mitigated with collateral of all kinds – Letters of Credit (LCs), Parental Guarantees (PGs), asset liens and sometimes cash. At the time of passage of the Dodd-Frank Act, we understood from the legislative language, as well as from letters and

statements by the principal authors of the legislation, that end-users would be exempted from any requirement to post **cash** margin. Unfortunately, margin rules proposed by the prudential banking regulators this past summer create uncertainty by reserving to the regulators the authority to, *de facto*, impose margin on end-users by requiring that such margin be collected by our swap-dealer counterparties. While the Coalition supports the Grimm-Peters-Owens-Scott bill, we are hopeful that, as it works its way through the legislative process, the bill can be expanded to cover financial end-users such as small banks, as well as non-financial end-users.

We are also very concerned about the regulators' proposed restrictions on using non-cash collateral to satisfy margin requirements. These restrictions could force companies to either abandon effective risk-mitigation strategies or critical capital expenditures. Furthermore, based on Federal Reserve data for bank lending (drawn facilities) in the US of $550BN, additional interest charges passed on to corporations are estimated to be $2.8BN annually as a result of the Dodd-Frank Act. And, a survey conducted by the Coalition found that companies would have to hold aside on average $269 million of cash or immediately available bank credit to meet a 3% initial margin requirement. Though the rule proposed by banking regulators may or may not require this magnitude of collateral, in our world of finite resources and financial constraints, this is a direct dollar-for-dollar subtraction from funds that we would otherwise use to expand our plants, build inventory to support higher sales, undertake research and development activities, and ultimately sustain and grow jobs. The aforementioned study extrapolated the effects across the S&P 500 to predict the consequent loss of 100,000 to 130,000 direct and indirect jobs. The effect on the many thousands of end-users beyond the S&P 500 would be proportionately greater. We would also have to make a considerable investment in information systems that would replicate much of the technology in a bank's trading room for marking to market and settling derivatives transactions, thus further depleting our working capital. A potential consequence of margin rules is liquidity risks for end-users that require us to increase debt levels and funnel cash from productive investments. In fact, a June 13, 2011, an Office of the Comptroller of the Currency (OCC) study provided an estimate of incremental initial margin requirements for large banks of $2TR, much of which we believe will be collected from their end-user counterparties. Consequently, we need Congress to step in and clarify the ability of end-users and banks to continue to manage counterparty risk without unnecessary initial and variation margin requirements.

Now, let me turn to the not yet introduced legislative proposal that seeks to clarify the swap dealer definition. A properly-tailored definition of "swap dealer" is another crucial element to ensuring that burdensome requirements such as mandatory margin, capital and clearing are not improperly forced upon non-financial end-users. The Dodd-Frank Act regulates swap dealers and major swap participants differently than end-users and appropriately so. But it is very important that the definition be tailored to capture persons that are actually in the business of providing dealer services to end-users, not the end-users themselves. Furthermore, to the extent end-users engage in only a small amount of customer-facing swap activity that is tied to their core non-financial businesses (e.g., manufacturing, processing, marketing), and whose dealing does not create systemic risk, they should not be treated as swap dealers. To that end, the *de minimis* exception to the definition of "swap dealer" **must** be set in legislation at a reasonable level that protects end-users from being regulated the same as the largest swap dealers that are potentially systemically risky. In addition, a company should not be regulated as a swap dealer simply because it makes a market for its own affiliates. Inter-affiliate trades should not be subject to regulations designed for market-facing transactions, and should not be a factor for determining whether a company is a swap dealer.

With that in mind, let me briefly offer my thoughts on H.R. 2779, also referred to as the Stivers-Fudge bill. Constellation Energy, like many other companies, uses a business model through which we limit the number of affiliates within our corporation that enters into derivatives transactions with external and other swap dealer counterparties. Rather than having each corporate subsidiary transact individually with external counterparties, a single or limited number of corporate entities face dealers and other counterparties in the market. This helps our company centralize risk taking, accountability and performance management. These entities then allocate transactions to those affiliates seeking to mitigate the underlying risk. This allocation is done by way of "inter-affiliate swaps" – or swaps between commonly controlled entities. This structure allows us to more effectively manage our corporate risk on an enterprise basis and to secure better pricing on our derivatives transactions. The transactions are largely "bookkeeping" in nature and do not create systemic risk. Using affiliates to transact has always been a healthy part of the way many companies internally centralize risk and manage overall

performance. For example, small farmers and ranchers, utilities, and car manufacturers, to name a few, perform their hedging transactions in this way.

As we understand it, however, regulators are considering whether to subject inter-affiliate swaps to the same set of requirements that would apply to swaps with external dealer counterparties – possibly including margin, clearing, real-time reporting, and other requirements. In my mind, this would be a mistake, imposing substantial costs on the economy and on consumers. That is why we strongly support the Stivers-Fudge bill, which recognizes that inter-affiliate swaps do not create systemic risk and that consequently, as a category, inter-affiliate swaps should not be subject to regulation as if they were outward-facing. The Stivers-Fudge bill would exempt a category of swaps, not a particular type of entity from regulation. That is precisely what the Administration did in exempting foreign exchange swaps and forwards and it is the right approach here as well.

Finally, let me turn to H.R. 1840, which focuses on cost-benefit analysis for any proposed rules. We firmly believe that rigorous cost-benefit analysis creates better rules. By first analyzing how a regulation will affect individuals, companies, other stakeholders, and the integrity of the overall market, a regulatory agency can avoid making the mistake of putting a rule in place that has adverse and unintended effects. The CFTC is subject to a cost-benefit analysis requirement, but it does not require the regulator to consider such key factors as available alternatives to regulation, whether the regulation is tailored to impose the least burden possible while achieving its goals, and whether the regulation maximizes net benefits. These and other factors would be required to be considered under the Conaway-Quigley bill. The CFTC should conduct a rigorous cost-benefit analysis for each proposed rules' impact on market liquidity, price discovery, as well as the potential costs to existing market participants and participants that may consider entering the market in the future.

As we saw when the SEC's proxy access rule was overturned by the courts, inadequate consideration of costs, benefits, and comments made during the rulemaking process does not establish a foundation that can sustain a rulemaking. The Conaway-Quigley bill would require the CFTC to undertake a structured and rigorous cost-benefit analysis when it promulgates rules; thus, ensuring a better process more likely to achieve statutory goals while limiting substantial societal costs.

In conclusion, I want to thank Chairman Lucas, Ranking Member Peterson and Members of the Committee for convening this hearing and affording me the opportunity to testify. Ensuring that Congressional intent is followed by the CFTC is critically important to the entire end-user community. I had hoped after passage of the Dodd-Frank Act that future legislation would not be required to deal with the concerns I have outlined here today. However, if legislation is not passed to clarify the statute's intent, end-users risk being captured as swap dealers and the end-user exemptions included in the bill would be null and void. It is important to remember that end-users rely on derivatives to reduce risk; bring certainty and stability to their businesses; and, ultimately to benefit their customers. We did not contribute to the financial crisis and we do not pose a threat to the financial system.

I would like to leave you with this final comment. As you probably know, the electricity industry is comprised of a number of types of entities, which include electric co-ops; investor owned utilities, which could be vertically integrated or merchant generators; and, public power organizations. These groups represent every electric customer in the United States and rarely agree on any public policy. However, if these regulations are improperly implemented by the CFTC, then it could cause electricity prices to rise for every consumer in America. That is why when it comes to Title VII of the Dodd-Frank Act we are in 100% alignment that end-users must not be captured as swap dealers or forced to clear all of their transactions.

Thank you for your time and I look forward to your questions.

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