

Testimony of the Honorable Glenn English, CEO
National Rural Electric Cooperatives Association

Submitted to the

United States House
Committee on Agriculture
July 21, 2011

Mr. Chairman, Mr. Peterson, and Members of the Committee, thank you for holding this hearing on Derivatives Reform: The View from Main Street. We appreciate the opportunity to discuss how the implementation of the Dodd Frank Act could negatively impact the rural electric cooperatives' ability to keep electric bills affordable for our consumer-members on Main Street, and on the farm. Any costs for the rural electric cooperatives resulting from regulatory overreach by the Commodity Futures Trading Commission (CFTC) will come out of the pockets of our consumer-members who live in some of the poorest areas in the country.

The National Rural Electric Cooperative Association (NRECA) is the not-for-profit, national service organization representing over 900 not-for-profit, member-owned, rural electric utilities, which serve 42 million customers in 47 states. NRECA estimates that cooperatives own and maintain 2.5 million miles or 42 percent of the nation's electric distribution lines covering three-quarters of the nation's landmass. Cooperatives serve approximately 18 million businesses, homes, farms, schools (and other establishments) in 2,500 of the nation's 3,141 counties. Our member cooperatives serve over 7 million member owners in Congressional Districts represented on this Committee.

Cooperatives still average just seven customers per mile of electrical distribution line, by far the lowest density in the industry. These low population densities, the challenge of traversing vast, remote stretches of often rugged topography, and the increasing volatility in the electric marketplace pose a daily challenge to our mission: to provide a stable, reliable supply of affordable power to our members—including constituents of many members of the Committee. That challenge is critical when you consider that the average household income in the service territories of our member co-ops lags the national average income by over 14%.

Mr. Chairman, the issue of commodity derivatives and how they should be regulated is something with which I have a bit of personal history going back twenty years when I served on this Committee. Accordingly, I am grateful for your leadership in pursuing the reforms necessary to increase transparency and prevent manipulation in this complex global marketplace.

NRECA's electric cooperative members, primarily generation and transmission cooperatives, need predictability in the price for power, fuel, transmission, financing, and other supply inputs if they are to provide stable, affordable rates to their members, including farmers in your Districts. As not-for-profit entities, we are not in the business of making money or trading financial instruments. Rural electric cooperatives use a range of energy and capacity contracts to keep costs down by reducing the commercial risks associated with electricity, capacity, and

necessary electricity production inputs. These contracts include both traditional commercial transactions and commodity derivatives. Some number of those contracts may be considered “swaps” under Dodd-Frank, but we don’t know yet which ones because – a full year later – the CFTC has not yet defined the most basic term in the statute. How those contracts are ultimately labeled could have dramatic impacts for cooperative consumers.

Regardless of labels, it is important to understand that electric co-ops are engaged in activities that are pure hedging, or commercial risk management. We DO NOT use commercial transactions, commodity derivatives or swaps for speculation or other non-hedging purposes.¹ We are in difficult economic times, making it more important than ever for cooperatives to be able to use whatever tools may be available for managing commercial risk on behalf of our members.

Most of our hedges are bilateral commercial transactions in the OTC market. Many of these transactions are entered into by cooperatives using as their agent a risk management provider called the Alliance for Cooperative Energy Services Power Marketing or ACES Power Marketing. ACES was founded a decade ago by many of the electric co-ops that still own this business today. Through diligent credit risk-management practices, ACES and our members make sure that the counterparty taking the other side of a hedge transaction is financially strong and secure – whether that counterparty is a financial institution, a natural gas producer or an investor-owned electric utility.

Even though the financial stakes are serious for us, rural electric co-ops are not big participants in the global derivatives market, which is estimated at \$600 trillion dollars. Our members participate in only a fraction of that market, and are simply looking for an affordable way to manage commercial risk and price volatility for our consumers. Because many of our co-op members are so small, and because energy markets are so volatile, legislative or regulatory changes that would dramatically increase the cost of hedging or prevent us from hedging all-together would impose a real burden. If commodity derivatives are unaffordable, then these price risks will be left unhedged and resulting cost increases will be passed on dollar-for-dollar to the consumer, where these risks would be unmanageable.

Electric cooperatives are owned by their consumers. Those consumers expect us, on their behalf, to protect them against volatility in the energy markets that can jeopardize their small businesses and adversely impact their family budgets. The families and small businesses we serve do not have a professional energy manager. Electric co-ops perform that role for them and should be able to do so in a cost effective way.

¹ For convenience, the remainder of the testimony will refer to commodity derivatives, but it is important to remember that those cooperative hedges that could ultimately be regulated as “swaps” include both commercial derivatives and traditional commercial contracts that were never before treated as derivative products, such as capacity contracts, reserve sharing agreements, and the all-requirements contracts that have traditionally provided financial backing to loans from the Rural Utilities Service.

Our Concerns with Implementation of the Dodd-Frank Act are as follows:

The July 16, 2011 Order

As this Committee is aware, the effective date of the Dodd-Frank Act came and went on July 16, 2011, without final rules being in place for a definitive new market structure for “swaps.” Congress made some of the provisions of the Dodd-Frank Act automatically effective on the unrealistic assumption that the new market structure for the diverse global swaps markets would take shape within a one-year time frame. Several of those automatically effective provisions deleted the exclusions and exemptions upon which commercial entities rely to transact in the OTC markets for nonfinancial commodities like power, natural gas, electric transmission and other common commercial risk transactions. In an attempt to prevent a possible disruption of commodity and derivatives markets, including power supply and fuel supply contracting, on July 14, 2011, the CFTC issued the “Effective Date Order”. Although the rural electric cooperatives, as part of the Not-for-Profit Electric Trade Associations Coalition, made a request for certain “grandfather relief” to the CFTC in September 2010 and again in May 2011, the CFTC has not addressed those requests.

The CFTC has extended until December 31, 2011 the timeline during which it intends to propose and finalize rules to establish the new regulatory market structure for “swaps.” The CFTC has also granted “temporary exemptions” from the current Commodity Exchange Act provisions to allow parties to transact in commodities and related derivatives during this interim period. This temporary relief automatically expires as of the earlier of December 31, 2011 or the date on which the final CFTC rule is effective in respect of any Dodd-Frank Act provision. This means a busy fall for CFTC rulemakings and the potential for further uncertainty as to whether (and when) the CFTC will again address these expiring temporary exemptions.

It is our hope that Chairman Gensler has addressed these issues before the Committee today to provide more guidance for energy end-users who need legal certainty and the ability to continue to use OTC derivatives to provide affordable and reliable power for American consumers while the regulators finalize their new markets. Our members enter into long term contracts to hedge our public service commitments and our infrastructure project costs. We remain concerned that temporary 6 month exemptions may not give our counterparties and financing sources much comfort in these long-term commercial hedging transactions.

The Definition of “Swap”

The most important term in the Dodd-Frank Act -- because it defines the scope of the CFTC’s regulatory authority -- is “swap.” NRECA is concerned that if the CFTC defines that term too broadly, it could bring under the CFTC’s jurisdiction commercial transactions that cooperatives and others in the energy industry have long used to manage electric grid reliability and to provide long-term price certainty for electric consumers. It is our belief that the CFTC must draw clear lines between “swaps,” which are subject to the CFTC’s jurisdiction and nonfinancial commodity forward contracts. The CFTC should make it clear in its rules that “swap” does not include commercial trade options that settle physically, or commercial commodity contracts that contain option-like provisions, including the full requirement contracts that even the

smallest cooperatives use to hedge their needs for physical power and natural gas generation. Further, CFTC should draw clear lines in its rules between “swaps” and those long-term power supply and generation capacity contracts, reserve sharing agreements, transmission contracts, emissions contracts and other transactions that are subject to FERC, EPA, or state energy or environmental regulation.

These non-financial transactions between non-financial entities have never been considered “products” or “instruments” or been traded with or between financial institutions for speculative purposes. They were not created to “trade”, they were developed to protect the reliability of the grid by ensuring that adequate generation resources will be available to meet the needs of consumers. These transactions do not pose any systemic risk to the financial system, nor should they cause concern to a regulator that is focused on fair, liquid and secure trading markets for standardized products. These are commercial contracts.

The CFTC must show restraint and interpret the term “swap” narrowly, as intended by Congress. If these commercial contracts were to be regulated by the CFTC as “swaps,” such regulation could impose enormous new costs on electric consumers and could undermine reliability of electric service.

The CFTC must also write clear rules that plainly explain which transactions will and will not be subject to regulation as “swaps.” Cooperatives and other non-financial commercial end users cannot be left in the dark, uncertain which transactions will subject them to increased regulatory burdens. That uncertainty can be as damaging as rules that clearly overreach.

In the Dodd-Frank Act, Congress excluded from the definition of “swap,” the “sale of a nonfinancial commodity... so long as the transaction is intended to be physically settled.” NRECA asks Congress to insist that the CFTC read this language as it was intended -- to exclude from regulation these kinds of commercial transactions that utilities use in the normal course of business to hedge commercial risks and meet the needs of electric consumers reliably and affordably.

Margin and Clearing Requirements

In general, co-ops are capital constrained. We and our members would prefer that cash remain in our members’ pockets rather than sitting idle in large reserve accounts to pay margin or capital costs of our counterparties. At the same time, we have significant capital investment demands, such as building new generation and transmission infrastructure to meet load growth, installing equipment to comply with clean air standards, and maintaining fuel supply inventories. Maintaining 42% of the nation’s electrical distribution lines requires considerable and continuous investment.

Congress respected those constraints in Dodd-Frank by establishing an “end-user exemption” that exempted those entities – like cooperatives – that use swaps solely to hedge commercial risk obligations. End users may choose to forgo the requirements to trade their swaps on regulated exchanges, which would require paying “margin” (posting collateral) to a dealer or clearing entity for those swaps. If properly implemented by regulation, that exemption would leave millions of dollars in electric consumers’ pockets that might otherwise sit in margin accounts or be paid in capital fees to financial institutions.

I want to remind you that we are NOT looking to hedge in an unregulated market for standardized swaps. NRECA DOES want swaps markets to be transparent and free of manipulation.

The problem is that requiring cooperatives' hedges to be centrally cleared or, if they are not cleared, still subjected to margin requirements would be unaffordable for most co-ops and would provide no value to the markets or to the nation. Our hedging transactions do not impose any of the systemic risk Dodd-Frank was intended to address. Yet any "initial margin" or "variance" margin requirements on our transactions under broad CFTC rules could force our members to post hundreds-of-millions of dollars in idle collateral that our consumers cannot afford to provide.

If the CFTC implements Dodd-Frank's end-user exemption too narrowly, the resulting clearing and margining requirements could force cooperatives to postpone or cancel needed investment in our infrastructure, borrow to fund margin postings, abandon hedging, or dramatically raise rates to consumers to raise the required cash to post as margin. Of course, whatever choice co-ops made would lead to the same result: increased electric bills for 42 million cooperative members.

Reporting Requirements

Mr. Chairman, the Dodd-Frank Act quite properly allows the CFTC to require reporting of those swaps traded on regulated exchanges, and those swaps involving swap dealers or other financial entities. That information is critical to providing transparency to those markets. Unfortunately, the CFTC is proposing to move far beyond the reporting requirements in the Act to also require utilities to report a significant volume of information for those end-user transactions that Congress exempted from Dodd-Frank's central clearing requirements. And, if no dealer is involved (as is the case in a lot of our transactions with other energy companies), the CFTC's rules will require one of the nonfinancial counterparties to report – perhaps "in real time." In our energy markets, many utility-to-utility transactions are entered into between two end-users, and there are no swap dealers or major swap participants to bear the reporting burdens that these types of dealer entities are accustomed to.

I encourage the Committee to urge the CFTC to reduce this reporting process burden, as permitted by the law. We are requesting that the CFTC adopt a "CFTC-lite" form of regulation for non-financial entities like the cooperatives. The CFTC should let us register, keep records and report in a less burdensome and less frequent way – not as if we were swap dealers or hedge funds. For example, it should be sufficient to require end-users to make a single representation that they will rely on the end-user exemption (and are bona fide hedgers) using swaps exclusively to hedge commercial risk. Once they have made that representation, they should not have to report those transactions any more frequently than is now required by the Federal Energy Regulatory Commission.

As explained above, these transactions represent a miniscule fraction of the global swap market and pose no systemic risk to the financial markets, making more frequent reporting unnecessarily expensive.

Exemptions for FERC-regulated and 201(f) transactions

Congress recognized in the Dodd-Frank Act that elimination of the Commodity Exchange Act's exemption for energy transactions could lead to duplicative and potentially conflicting regulation of transactions now subject to FERC regulation, and could lead to unnecessary and expensive regulation of transactions between cooperative and government-owned utilities. Accordingly, it directed the CFTC to grant those transactions a "public interest waiver" from its regulation if it found such a waiver to be in the public interest.

No entity has yet sought such an exemption because the rules from which they would be seeking exemption have not yet been written. The CFTC can initiate the public interest waiver process, but it has not done so. Because the industry does not yet know what the CFTC will consider to be a "swap" or whether utility hedging efforts will be exempted from central clearing and margining requirements as end-user transactions, it does not yet know how critical it will be to pursue these additional avenues for relief. We certainly hope that the CFTC will choose to write its rules in a manner that minimizes potential conflicts with FERC regulation and that minimizes potential costs for transactions between cooperatives or government owned utilities. We further urge the CFTC not to impose a regulatory regime on individuals for commercial transactions involving nonfinancial energy commodities.

Nevertheless, should it become necessary to pursue additional exemptions or public interest waivers, NRECA hopes that the CFTC will recognize that Congress intended in Dodd-Frank to address systemic risk in financial markets *without* disrupting existing markets for electricity, and that the CFTC will entertain the industry's applications for further exemptions and public interest waivers if and or when they are submitted.

The Definition of "Swap Dealer"

The definition of "swap dealer" has just recently become a concern for the rural electric cooperatives. The regulators have suggested they might interpret this definition broadly enough to sweep in our not-for-profit members. If so, such an interpretation has the potential to be one of the more damaging unintended consequences of the Dodd-Frank Act. If our members were considered "swap dealers," those cooperatives would be subject to a slew of new capital-draining requirements, business practices, and financial markets regulations that Congress intended to impose on Wall Street derivatives dealers. To put it bluntly - it would be an incredible regulatory overreach for the CFTC to apply the definition of "swap dealer" to rural electric cooperatives – who are obviously not in the business of derivatives dealing, but instead are not-for-profit end-users of nonfinancial energy derivatives to hedge commercial risk and protect consumers from price volatility in wholesale power markets. The rural electric cooperatives' core mission is keeping the lights on for farmers, families and small businesses in rural America, not dealing in the global swaps markets. There are no "Wall Street derivatives dealers" in our membership. We believe it should be obvious to the CFTC that Congress did not intend for end-users, particularly not-for-profit end-users, to be regulated as "swaps dealers." We are happy to continue to explain our business to the regulatory staff, but we urge the CFTC to keep a clear focus on legislative intent.

Treatment of Cooperative Lenders

Rural electric cooperatives banded together four decades ago to form their own financing cooperative to provide private financing to supplement the loan programs of the US Department of Agriculture's Rural Utilities Service (RUS). Today, this nonprofit cooperative association, the National Rural Utilities Cooperative Finance Corporation (CFC), provides electric cooperatives with private financing for generating stations and other facilities to deliver electricity to residents of rural America, and to keep rates affordable. In this context, CFC, which is owned and controlled by electric cooperatives, uses OTC derivatives to mitigate interest rate risks, and to tailor loans to meet electric cooperative needs. CFC does not enter into derivative transactions for speculative purposes, nor is it a broker or a dealer. CFC only enters into derivatives necessary to hedge the risks associated with lending to electric cooperatives. If CFC is unnecessarily swept up in onerous new margining and clearing requirements, electric cooperatives will likely have to pay higher rates and fees on their loans, and those costs will be passed on to rural consumers.

We ask that CFC's unique nature as a nonprofit cooperative association owned and controlled by America's consumer-owned electric cooperatives be appropriately recognized. Electric cooperatives should not be burdened with additional costs that would result by subjecting their financing cooperative, CFC, to margining and clearing requirements.

Conclusion

Mr. Chairman, at the end of the day, we are looking for a transparent market for standardized trading products, and continued cost-effective access to the OTC commodity transactions which allow cooperatives to hedge commercial risk and price volatility for our members. If we are to do that, the CFTC must define "swap" in clear terms to exclude those pure hedging transactions in nonfinancial commodities that the industry uses to preserve reliability and manage long-term power supply costs; must give real meaning to Dodd-Frank's end-user exemption; must limit unnecessary recordkeeping and reporting costs for end-users; and must limit duplicative and unnecessary regulation of cooperatives and other electric utilities.

Rural electric cooperatives are not financial entities, and therefore should not be burdened by new regulation or associated costs as if we were financial entities. We believe the CFTC should preserve cost-effective access to swap markets for non-financial entities like the co-ops who simply want to hedge commercial risks inherent in our nonfinancial business – our mission is to provide reliable and affordable power to American consumers and businesses.

I thank you for your leadership on this important issue. I know that you and your committee are working hard to ensure these markets function effectively. The rural electric co-ops hope that at the end of the day, there is an affordable way for the little guy to effectively manage risk.

Thank you.



National Rural Electric Cooperative Association

A Touchstone Energy® Cooperative 



BIOGRAPHY OF GLENN ENGLISH CHIEF EXECUTIVE OFFICER

In March 1994, Glenn English became the fourth chief executive officer of the National Rural Electric Cooperative Association (NRECA). As chief spokesman for the nation's consumer-owned, cooperative electric utilities, he represents the national interests of electric cooperatives and their consumers before the United States Congress and Executive Branch federal agencies.

Foremost among the issues facing electric cooperatives today is the priority to promote and protect the electric cooperative business model in the political and business arenas. Legislative and regulatory actions regarding the electric utility industry and their impact on electric cooperatives continue to focus association efforts on consumer advocacy. English is a strong advocate for small-business and residential electric consumers as lawmakers, regulators and other influentials attempt to make their mark on electric utility change at the state, regional and national levels. He is a frequent speaker from the co-op and consumer perspective at meetings of business, industry, and consumer groups, as well as electric co-op and allied groups around the country.

Prior to assuming the NRECA post, English was elected by the people of Oklahoma's 6th District to 10 terms in the U.S. House of Representatives; he was first elected in 1974. His leadership positions included chairmanship of the House Agriculture Subcommittee on Environment, Credit, and Rural Development; and the House Government Operations Subcommittee on Government Information, Justice, and Agriculture.

NRECA is the national service organization that represents the nation's more than 900 consumer-owned electric cooperatives, which provide electric service to 40 million people in 47 states. Visit NRECA's web site at www.nreca.coop.