Statement of Richard McMahon
On behalf of the Edison Electric Institute, American Public Power Association, and Electric Power Supply Association

Before the Subcommittee on General Farm Commodities and Risk Management
Committee on Agriculture
U.S. House of Representatives

Tuesday, February 15, 2011

Chairman Conaway and members of the Subcommittee, thank you for this opportunity to discuss the role of over-the-counter (OTC) derivatives markets in helping utilities and energy companies insulate our customers from the volatility of commodity price risk, as well as some of the key issues we see in the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

I am Richard McMahon, Vice President of Energy Supply and Finance for the Edison Electric Institute (EEI). EEI is the trade association of U.S. shareholder-owned electric utilities, with international affiliates and industry associates worldwide. EEI's U.S. members serve 95 percent of the ultimate electricity customers in the shareholder-owned segment of the industry, and represent approximately 70 percent of the total U.S. electric power industry.

I also am testifying on behalf of the American Public Power Association (APPA) and the Electric Power Supply Association (EPSA). APPA represents the nation's more than 2,000 community-owned electric utilities. EPSA is the national trade association representing competitive power suppliers, including generators and power marketers.

<u>Utilities and Energy Companies Hedge Risk</u>

Wholesale natural gas and electric power are, and have been historically, two of the most volatile commodity groups. Our members use natural gas extensively as a fuel to generate electric power, as well as distribute natural gas to consumers in their homes. Additionally, utilities purchase wholesale electricity from generators and marketers to meet consumer demand.

The goal of our members is to provide their customers with reliable service at affordable and stable rates. Therefore, it is essential to manage the price volatility inherent in wholesale commodity markets for natural gas and electric power. Our members purchase fuel and sell power at thousands of delivery points throughout the U.S. They need the ability to use OTC swaps because existing futures contracts cover limited natural gas and electricity delivery points. The derivatives market has proven to be an extremely effective tool in insulating our customers from this risk and price volatility. Utilities and energy companies use both exchange traded and cleared and OTC swaps for natural gas and electric power to hedge commercial risk. About one-half of our gas swaps and about one-third of our power swaps are traded on exchanges.

Why the Margin Issue is Critically Important

Utilities and energy companies are financially stable and highly creditworthy. On average EEI's members are rated BBB. As a result, utilities and their customers get a significant cost benefit from low or no collateral requirements for their OTC derivatives transactions. In some cases, our members provide a letter for credit or a lien on assets as collateral to support their obligations on swaps. Exchanges and clearinghouses are generally blind to the financial health of their participants and demand cash margin deposits, both initial and variation margin.

Our industry is in the midst of a major capital spending program to enhance the electric grid, make our generation fleet cleaner and bring new technologies to our customers. Last year, shareholder-owned electric utilities' capital expenditures (CAPEX) were $83 billion, and we expect this pace of capital investment to continue throughout the decade. The capital investments of all of our members are contributing to our nation's economic recovery and job growth.

A margin requirement on all utility OTC swaps would have an average annual cash flow impact of between $250 million-$400 million per company. This "dead capital" tied up in margin accounts at clearinghouses would need to be funded by our customers.

If our members are forced to post margin on all of our OTC transactions, we have three equally undesirable choices:

- Re-direct dollars from our core infrastructure capital spending programs to margin accounts at clearinghouses;
- Borrow the money to post in margin accounts and pass that cost through to our customers in rates; or
- Curtail our derivatives hedging programs and pass the commodity price volatility in gas and electric power through to our customers.

Because of these undesirable consequences, the National Association of Regulatory Utility Commissioners (NARUC) passed a resolution in support of the industry's goal of maintaining our ability to use OTC derivatives without cash margining requirements (see attached).

We were very pleased to hear Commodity Futures Trading Commission (CFTC) Chairman Gensler's testimony last week before the full House Agriculture Committee in which he stated, "Proposed rules on margin shall focus on transactions between financial entities rather than those transactions that involve non-financial end-users." It is essential that this now unambiguous direction from the CFTC Chairman be carried through fully in implementation of the Dodd-Frank Act. We believe this was the clear intent of the Congress, and it was confirmed in the Dodd-Lincoln letter, which was drafted as part of the conference committee to fully clarify the intent of the Congress to fully exempt end-users from margining and burdensome CFTC compliance obligations. (see attached)

Need for a Proper Sequencing and Implementation Timetable

We support the overarching goals of the Dodd-Frank Act to bring greater transparency and oversight to derivatives markets and to address systemic risk to the economy. Additionally, we compliment the CFTC Chairman, Commissioners and staff for their hard work and openness in seeking input from different market participants during the implementation process.

However, the Dodd-Frank Act left many important issues to be resolved by regulators and set impractically tight deadlines on rulemakings by the agencies charged with implementation. To further complicate matters, many of the complex issues raised by scores of rulemakings are interrelated. As a result, interested parties are unable to comment on the proposed rules in a meaningful way, because they cannot know the full effect of the complete universe of proposed rules. For example, it is difficult to comment on the proposed swap dealer definition, position limits, and recordkeeping and reporting rules for swaps before the proposed definition of a swap has been issued.

Concerns Regarding Implementation Burdens on End-Users

In a provision of the Dodd-Frank Act known as the "end-user clearing exception," Congress gave our members and other end-users of swaps the flexibility to elect not to clear swaps that they use to hedge commercial risk.

The CFTC's proposed rule implementing this provision would require an end-user to report roughly a dozen items of information to the CFTC every time it elects to rely on the end-user clearing exception for a swap. The required information for each swap includes representations that:

- it is a non-financial entity,
- the swap is hedging commercial risk,
- it has certain credit arrangements in place, and
- in the case of publicly-traded companies like most of our members, that an appropriate committee of the board of directors (or equivalent body) has reviewed and approved its decision not to clear.

The CFTC does not need such representations from our members and other end-users about every one of their non-cleared swaps to prevent abuse of the end-user clearing exception. Our members and other end-users understand that knowingly providing the CFTC with inaccurate information is a very serious violation of the Commodity Exchange Act (CEA). That is more than sufficient incentive for end-users to rely on the end-user clearing exception only when they are authorized to do so.

We request that the Subcommittee emphasize to the CFTC that it can implement the end-user clearing exception, consistent with Congress's intent, by requiring end-users to:

- represent once that they will only rely on the end-user clearing exception for swaps that hedge commercial risk;

- inform the Commission once how they *generally* meet their financial obligations associated with entering into non-cleared swaps (coupled with an obligation to provide notice of material changes); and

- in the case of publicly-traded companies, maintain a record that shows that an appropriate committee of the board of directors (or equivalent body) has reviewed and approved their decision not to clear.

In addition to our concerns about the CFTC's proposed implementation of the end-user clearing exception, we have serious concerns about how the CFTC plans to define "swap dealer." The CFTC's proposed rule includes very expansive language about the types of activity—including "accommodating" the demand of third parties for swaps—that the CFTC views as dealing activity. At the same time, the Commission has proposed to implement the "not as part of a regular business" and "de minimis" exceptions to the definition of "swap dealer" in a very restrictive manner. The result could be that commercial end-users are inappropriately miscast as swap dealers. If our members, which primarily engage in hedging activities, are caught within the definition of "swap dealer," not only will they face the costs of margin requirements, but they also will be subject to additional capital and collateral requirements (not yet defined by the CFTC), cost of IT systems for additional reporting, and other costly requirements not appropriate for end-users.

The CEA, prior to the passage of the Dodd-Frank Act, excluded physical forward transactions from the CFTC's jurisdiction over futures contracts. The definition of swap in the Dodd-Frank Act includes options on physical commodities, but excludes "any sale of a nonfinancial commodity . . . so long as the transaction is intended to be settled." The CFTC has issued proposed rules on swap position reporting and on agricultural swaps which indicate that the CFTC intends to regulate options on physical commodities as swaps or "swaptions." The end-user community is concerned about the CFTC's proposal because many contracts for the delivery of power in the electric industry, such as capacity and requirements contracts, include price, volume or other optionality. Including these end-user to end-user contracts in the definition of swap would greatly expand the scope of the CFTC's regulation over the electric utility industry and potentially would subject end-users to a number of burdensome regulatory requirements. We urge Congress to restrain CFTC's regulatory authority in this critical area of our business.

Conclusion

Thank you for your leadership and interest in implementation of the Dodd-Frank Act. We appreciate your role in helping to ensure that utilities and energy companies can continue to be able to use OTC derivatives to cost-effectively help protect our nation's consumers from volatile wholesale natural gas and power commodity prices.

Resolution on Financial Reform Legislation Affecting Over-the-Counter Risk Management Products and Its Impacts on Consumers

WHEREAS, There is a diverse group of end-users, consisting of electric and natural gas utilities, suppliers, customers, and other commercial entities who rely on over-the-counter ("OTC") derivative products and markets to manage electricity and natural gas price risks for legitimate business purposes, thereby helping to keep rates stable and affordable for retail consumers; *and*

WHEREAS, The United States Congress is considering financial reform legislation with the goal of ensuring that gaps in regulation, oversight of markets and systemic risk do not lead to economic instability; *and*

WHEREAS, Previous NARUC resolutions support federal legislative and regulatory actions that fully accommodate legitimate hedging activities by electric and natural gas utilities; *and*

WHEREAS, The proposed legislation would, among other things, provide the Commodity Futures Trading Commission (CFTC) with oversight of OTC risk management products, including mandatory centralized clearing and exchange trading of all OTC products; *and*

WHEREAS, Mandatory centralized clearing of all OTC contracts will increase expenses associated with hedging activity, and ultimately end-user prices, due to increased margin requirements; *and*

WHEREAS, A report by the Joint Association of Energy End-Users stated that the effect of margin requirements resulting from mandatory clearing for electric utilities would have the unintended effect of reducing or eliminating legitimate hedging practices and could jeopardize or reduce investments in Smart Grid technology; and for natural gas utilities and production companies could reduce capital devoted to infrastructure and natural gas exploration; *and*

WHEREAS, The laudable goals of reform that ensure market transparency and adequate regulatory oversight can be accomplished by means other than mandatory clearing of OTC risk management contracts and the anticipated extra expense. For example, a requirement that natural gas and electric market participants engaging in legitimate hedging report all OTC derivative transactions to a centralized data repository, like the CFTC, provides sufficient market transparency without the costs associated with mandatory clearing; *and*

WHEREAS, Proposed reforms would cause regulatory uncertainty with regard to the oversight of Regional Transmission Organizations (RTOs) and Independent System Operators (ISOs), where such uncertainty and/or overlapping jurisdiction can lead to negative impacts on liquidity, market confidence and reliability; *and*

WHEREAS, The Federal Energy Regulatory Commission (FERC), and the Public Utility Commission of Texas (PUCT) for Texas/ERCOT, as the regulators with the necessary expertise and statutory mandates to oversee electricity and natural gas markets to protect the public interest and consumers, should not be preempted by the financial reform legislation from being able to continue exercising their authority to ensure reliable, just and reasonable service and protect consumers; *and*

WHEREAS, Energy markets currently regulated by FERC or the PUCT (for Texas/ERCOT) under accepted tariffs or rate schedules should continue to be subject to FERC's and the PUCT's (for Texas/ERCOT) exclusive Federal jurisdiction, including jurisdiction over physical and financial transmission rights, and market oversight; and should themselves not be subject to CFTC jurisdiction as a clearinghouse due to the financial and other settlement services they provide those transacting in regional electricity markets; *now, therefore be it*

RESOLVED, That the Board of Directors of the National Association of Regulatory Utility Commissioners, convened at its 2010 Winter Committee Meetings in Washington, D.C., supports passage of financial reform legislation ensuring that electric and natural gas market participants continue to have access to OTC risk management products as tools in their legitimate hedging practices to provide more predictable and less volatile energy costs to consumers; *and be it further*

RESOLVED, That new financial legislation being considered by Congress should weigh the costs of potential end-user utility rate increases versus the benefits of new standards for the clearing of OTC risk management contracts used by natural gas and electric utilities for legitimate hedging purposes; *and be it further*

RESOLVED, That any federal legislation addressing OTC risk management products should provide for an exemption from mandatory clearing requirements for legitimate hedging activity in natural gas and electricity markets; *and be it further*

RESOLVED, That any exemption to the mandatory clearing requirement for OTC derivatives be narrowly tailored as to not allow excessive speculation in natural gas and electricity markets;
and be it further

RESOLVED, That the FERC, and the PUCT for Texas/ERCOT, charged with the statutory obligation to protect the public interest and consumers, should continue to be the exclusive Federal regulators with authority to oversee any agreement, contract, transaction, product, market mechanism or service offered or provided pursuant to a tariff or rate schedule filed and accepted by the FERC, or the PUCT for Texas/ERCOT; *and be it further*

RESOLVED, That NARUC authorizes and directs the staff and General Counsel to promote with the Congress, the Commodity Futures Trading Commission and other policymakers at the federal level, policies consistent with this statement.

Sponsored by the Committee on Gas, Consumer Affairs, and Electricity
Adopted by the NARUC Board of Directors February 17, 2010

United States Senate
WASHINGTON, DC 20510

June 30, 2010

The Honorable Chairman Barney Frank
Financial Services Committee
United States House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Chairman Colin Peterson
Committee on Agriculture
United States House of Representatives
1301 Longworth House Office Building
Washington, DC 20515

Dear Chairmen Frank and Peterson:

Whether swaps are used by an airline hedging its fuel costs or a global manufacturing company hedging interest rate risk, derivatives are an important tool businesses use to manage costs and market volatility. This legislation will preserve that tool. Regulators, namely the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and the prudential regulators, must not make hedging so costly it becomes prohibitively expensive for end users to manage their risk. This letter seeks to provide some additional background on legislative intent on some, but not all, of the various sections of Title VII of H.R. 4173, the Dodd-Frank Act.

The legislation does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk. If regulators raise the costs of end user transactions, they may create more risk. It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth.

Again, Congress clearly stated in this bill that the margin and capital requirements are not to be imposed on end users, nor can the regulators require clearing for end user trades. Regulators are charged with establishing rules for the capital requirements, as well as the margin requirements for all uncleared trades, but rules may not be set in a way that requires the imposition of margin requirements on the end user side of a lawful transaction. In cases where a Swap Dealer enters into an uncleared swap with an end user, margin on the dealer side of the transaction should reflect the counterparty risk of the transaction. Congress strongly encourages regulators to establish margin requirements for such swaps or security-based swaps in a manner that is consistent with the Congressional intent to protect end users from burdensome costs.

In harmonizing the different approaches taken by the House and Senate in their respective derivatives titles, a number of provisions were deleted by the Conference Committee to avoid redundancy and to streamline the regulatory framework. However, a consistent Congressional directive throughout all drafts of this legislation, and in Congressional debate, has been to protect end users from burdensome costs associated with margin requirements and mandatory clearing. Accordingly, changes made in Conference to the section of the bill regulating capital and margin requirements for Swap Dealers and Major Swap Participants should not be construed as changing this important Congressional interest in protecting end users. In fact, the House offer amending the capital and margin provisions of Sections 731 and 764 expressly stated that the strike to the base text was made "to eliminate redundancy." Capital and margin standards should be set to mitigate risk in our financial system, not punish those who are trying to hedge their own commercial risk.

Congress recognized that the individualized credit arrangements worked out between counterparties in a bilateral transaction can be important components of business risk management. That is why Congress specifically mandates that regulators permit the use of non-cash collateral for counterparty arrangements with Swap Dealers and Major Swap Participants to permit flexibility. Mitigating risk is one of the most important reasons for passing this legislation.

Congress determined that clearing is at the heart of reform – bringing transactions and counterparties into a robust, conservative and transparent risk management framework. Congress also acknowledged that clearing may not be suitable for every transaction or every counterparty. End users who hedge their risks may find it challenging to use a standard derivative contracts to exactly match up their risks with counterparties willing to purchase their specific exposures. Standardized derivative contracts may not be suitable for every transaction. Congress recognized that imposing the clearing and exchange trading requirement on commercial end-users could raise transaction costs where there is a substantial public interest in keeping such costs low (i.e., to provide consumers with stable, low prices, promote investment, and create jobs.)

Congress recognized this concern and created a robust end user clearing exemption for those entities that are using the swaps market to hedge or mitigate commercial risk. These entities could be anything ranging from car companies to airlines or energy companies who produce and distribute power to farm machinery manufacturers. They also include captive finance affiliates, finance arms that are hedging in support of manufacturing or other commercial companies. The end user exemption also may apply to our smaller financial entities - credit unions, community banks, and farm credit institutions. These entities did not get us into this crisis and should not be punished for Wall Street's excesses. They help to finance jobs and provide lending for communities all across this nation. That is why Congress provided regulators the authority to exempt these institutions.

This is also why we narrowed the scope of the Swap Dealer and Major Swap Participant definitions. We should not inadvertently pull in entities that are appropriately managing their risk. In implementing the Swap Dealer and Major Swap Participant provisions, Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies simply because they use swaps to hedge risk in their ordinary course of business. Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business. For example, the Major Swap Participant and Swap Dealer definitions are not intended to include an electric or gas utility that purchases commodities that are used either as a source of fuel to produce electricity or to supply gas to retail customers and that uses swaps to hedge or manage the commercial risks associated with its business. Congress incorporated a de minimis exception to the Swap Dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation.

Just as Congress has heard the end user community, regulators must carefully take into consideration the impact of regulation and capital and margin on these entities.

It is also imperative that regulators do not assume that all over-the-counter transactions share the same risk profile. While uncleared swaps should be looked at closely, regulators must carefully analyze the risk associated with cleared and uncleared swaps and apply that analysis when setting capital standards for Swap Dealers and Major Swap Participants. As regulators set capital and margin standards on Swap Dealers or Major Swap Participants, they must set the appropriate standards relative to the risks associated with trading. Regulators must carefully consider the potential burdens that Swap Dealers and Major Swap Participants may impose on end user counterparties – especially if those requirements will discourage the use of swaps by end users or harm economic growth. Regulators should seek to impose margins to the extent they are necessary to ensure the safety and soundness of the Swap Dealers and Major Swap Participants.

Congress determined that end users must be empowered in their counterparty relationships, especially relationships with swap dealers. This is why Congress explicitly gave to end users the option to clear swaps contracts, the option to choose their clearinghouse or clearing agency, and the option to segregate margin with an independent 3rd party custodian.

In implementing the derivatives title, Congress encourages the CFTC to clarify through rulemaking that the exclusion from the definition of swap for "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled" is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC's established policy and orders on this subject, including situations where commercial parties agree to "book-out" their physical delivery obligations under a forward contract.

Congress recognized that the capital and margin requirements in this bill could have an impact on swaps contracts currently in existence. For this reason, we provided legal certainty to those contracts currently in existence, providing that no contract could be terminated, renegotiated, modified, amended, or supplemented (unless otherwise specified in the contract) based on the implementation of any requirement in this Act, including requirements on Swap Dealers and Major Swap Participants. It is imperative that we provide certainty to these existing contracts for the sake of our economy and financial system.

Regulators must carefully follow Congressional intent in implementing this bill. While Congress may not have the expertise to set specific standards, we have laid out our criteria and guidelines for implementing reform. It is imperative that these standards are not punitive to the end users, that we encourage the management of commercial risk, and that we build a strong but responsive framework for regulating the derivatives market.

Sincerely,

Chairman Christopher Dodd
Senate Committee on Banking, Housing, and Urban Affairs
United States Senate

Chairman Blanche Lincoln
Senate Committee on Agriculture, Nutrition, and Forestry
United States Senate

Richard F. McMahon, Jr
Vice President
Edison Electric Institute

Richard McMahon is Vice President, Energy Supply and Finance for the Edison Electric Institute. In this capacity, he leads the two groups within EEI, the Energy Supply Group and the Finance, Tax and Accounting Group.

Mr. McMahon directs the industry's finance and Wall Street activities including financial analysis, investor relations, accounting and tax issues including advocacy before the Securities and Exchange Commission, as well as credit and wholesale market issues before the Federal Energy Regulatory Commission. He leads EEI's *Campaign to Invest America's Electric Future*. Also, he leads the industry's advocacy on OTC Derivatives and Financial Reform before the Congress and the Commodities Futures Trading Commission. He directs the Energy Supply staff in advancing public policy issues in fossil and renewable power, hydropower, fuel diversity and rail transportation issues.

Prior to this, Mr. McMahon served as EEI's Director, Competitive Strategies & Policy in EEI's Energy Services Group. In this capacity, he directed EEI's state legislative and regulatory advocacy program in 22 states.

Mr. McMahon was the founder of the EnviroTech Venture Capital Fund, capitalized at $52 million, and currently sits on its Advisory Board and Technical Liaison Committee.

Prior to joining EEI, Mr. McMahon worked in management positions at the National Association of Securities Dealers in the NASDAQ Stock Market.

Mr. McMahon completed the Stanford University Graduate School of Business Executive Program in Leadership in 2007. He holds a M.B.A. degree in Finance from the George Washington University in 1987 and a B.A. degree from Duquesne University in 1983.

He lives with his wife and 3 children in Northern Virginia.

January 2011

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2008.

Name: Richard McMahon

Organization you represent (if any): Edison Electric Institute

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1. **Please list any federal grants or contracts (including subgrants and subcontracts) <u>you</u> have received since October 1, 2008, as well as the source and the amount of each grant or contract. House Rules do <u>NOT</u> require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source:________________ **Amount:**________

Source:________________ **Amount:**________

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) <u>the organization</u> has received since October 1, 2008, as well as the source and the amount of each grant or contract:**

Source:________________ **Amount:**________

Source:________________ **Amount:**________

Please check here if this form is NOT applicable to you: ✓

Signature:________________

* Rule XI, clause 2(g)(4) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

PLEASE ATTACH DISCLOSURE FORM TO EACH COPY OF TESTIMONY.