Statement of Richard McMahon
On behalf of the Edison Electric Institute
On "The Future of the CFTC: End-User Perspectives"

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

Wednesday, July 24, 2013

Introduction

Chairman Conaway, Ranking Member Scott and Members of the Subcommittee, thank you for the opportunity to discuss the perspective of end-users on the future of the Commodity Futures Trading Commission (CFTC).

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 virtually all 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.

The electric power industry is the most capital-intensive industry in the United States—an $840 billion industry representing approximately three percent of real gross domestic product. Our industry is projected to spend approximately $90 billion a year through 2015 for major transmission, distribution and smart grid upgrades; cybersecurity measures; new, cleaner generating capacity; and environmental and energy-efficiency improvements.

My views are shared by the Electric Power Supply Association (EPSA), which is the national trade association for competitive wholesale electricity suppliers, including power generators and marketers. EPSA members include both independent power producers and the wholesale supply businesses of utility holding companies. EPSA members supply electricity nationwide with an emphasis on the two-thirds of the country located within a regional transmission organization or independent system operator (so-called "organized markets"). EPSA members and other competitive suppliers account for 40 percent of the installed electric generating capacity in the United States. These suppliers are the primary sources of electricity for most of Maine to Virginia, across to Illinois, and in Texas and California.

Our members are non-financial entities that primarily participate in the physical commodity market and rely on swaps and futures contracts primarily to hedge and mitigate their commercial risk. The goal of our member companies is to provide their customers with reliable electric service at affordable and stable rates, which has a direct and significant impact on

literally every area of the U.S. economy. Since wholesale electricity and natural gas historically have been two of the most volatile commodity groups, our member companies place a strong emphasis on managing the price volatility inherent in these wholesale commodity markets to the benefit of their customers. The derivatives market has proven to be an extremely effective tool in insulating our customers from this risk and price volatility. In sum, our members are the quintessential commercial end-users of swaps.

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") provides certain exemptions for non-financial end-users, recognizing that they are not the entities posing systemic risk to the financial system. Since passage of the Dodd-Frank Act, we have been actively working with the federal agencies, including the CFTC, as they work their way through the implementation process to ensure that the congressional intent of exempting non-financial end-users remains intact. Even though a majority of the rules have been promulgated by these agencies, concerns still surround some of the remaining issues important to electric companies.

Our members support the Dodd-Frank Act's primary goals of protecting the financial system against systemic risk and increasing transparency in derivatives markets. We believe, however, that there are areas where Congress should consider minor adjustments to ensure the Dodd-Frank Act achieves its purpose while not inadvertently impeding end-users' ability to hedge. As Congress examines possible modifications to the Commodity Exchange Act, we ask that you consider the following issues:

De Minimis Level

A new category of market participants, swap dealers, was created by the Dodd-Frank Act. These swap dealers must register with the CFTC and are subject to extensive recordkeeping, reporting, business conduct standards, clearing, and—in the future—regulatory capital and margin requirements. However, the Act directed the CFTC to exempt from designation as a swap dealer entities that engage in a de minimis quantity of swap dealing. The CFTC issued a proposed rule on the de minimis threshold for comment in early 2011. After review of hundreds of comments, a series of congressional hearings and after dozens of meetings with market participants, the CFTC set this de minimis threshold at $8 billion. However, it will then be reduced automatically to $3 billion in 2018 absent CFTC action.

We oppose such a dramatic reduction in the de minimis threshold without deliberate CFTC action. Inaction is always easier than action, and inaction should not be the default justification for such a major regulatory action. In addition, we believe the CFTC should not have the authority to change the de minimis level without a formal rulemaking process that allows stakeholders to provide input on what the appropriate threshold should be.

Absent these procedural changes, we are concerned a deep reduction in the de minimis level could result in commercial end-users being misclassified as swap dealers, hindering end-users' ability to hedge market risk while imposing unnecessary costs that eventually will be borne by consumers.

Margin Requirements

As I previously mentioned, the electric power industry is one of the most capital-intensive industries in the United States. With our industry projected to spend approximately $90 billion a year through 2015 for major upgrades to the electric system, requiring non-financial end-users to post margin could tie up much-needed capital that otherwise would be used to invest in local economies. With the lack of clarity on whether or not Prudential Regulators and possibly the CFTC plan on requiring non-financial end-users to post margin, Congress should clarify that it did not intend for margin requirements to apply to non-financial end-users.

In addition, we ask Congress to clarify that it did not intend for the CFTC and Prudential Regulators to place limitations on the forms of collateral swap dealers and major swap participants can accept from non-financial end-users if they agree to collateralize a swap as a commercial matter. We support bipartisan legislation that seeks to further clarify that end-users are exempt from margin requirements. H.R. 634, sponsored by Rep. Michael Grimm (R-NY), passed the House on an overwhelmingly bipartisan vote of 411-12. Similar legislation has also been introduced in the Senate—S. 888, sponsored by Sen. Mike Johanns (R-NE).

***Bona fide* Hedging**

On September 28, 2012, the U.S. District Court for the District of Columbia vacated final CFTC rules regarding position limits. These vacated rules defined the term *bona fide* hedging. As written in the CFTC's rule that was vacated, the definition was unnecessarily narrow and would have discouraged a significant amount of important and beneficial risk management activity. Specifically, the rule narrowed the existing definition considerably by providing that a transaction or position that would otherwise qualify as a *bona fide* hedge also must fall within one of eight categories of enumerated hedging transactions, a definitional change neither supported in nor required by the Dodd-Frank Act. This restrictive definition of *bona fide* hedging transactions could disrupt the commodity markets, make hedging more difficult and costly, and may increase systemic risk by encouraging end-users to leave a relatively large portion of their portfolios un-hedged.

Financial Entities

The Dodd-Frank Act defines the term "financial entity", in part, as an entity that is "predominantly engaged in activities that are in the business of banking, or in activities that are

financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956." Incorporating banking concepts into a definition that also applies to commercial commodity market participants has had unintended consequences.

Unlike our members, banks and bank holding companies generally cannot take or make delivery of physical commodities. However, banks and bank holding companies can invest and trade in certain commodity derivatives. As a result, the definition of "financial in nature" includes investing and trading in futures and swaps as well as other physical transactions that are settled by instantaneous transfer of title of the physical commodity. An entity that falls under the definition of a "financial entity" is generally not entitled to the end-user exemption—an exemption that Congress included to benefit commercial commodity market participants—and can therefore be subject to many of the requirements placed upon swap dealers and major swap participants. In addition, the CFTC has used financial entity as a material term in numerous rules, no-action relief, and guidance, including, most recently, its cross-border guidance. The Dodd-Frank Act allows affiliates or subsidiaries of an end-user to rely on the end-user exception when entering into the swap on behalf of the end-user. However, swaps entered into by end-user hedging affiliates who fall under the definition of "financial entity" cannot take advantage of the end-user exemption, despite the fact that the transactions are entered into on behalf of the end-user.

Many energy companies structure their businesses so that a single legal entity within the corporate family acts as a central hedging, trading and marketing entity – allowing companies to centralize functions such as credit and risk management. However, when the banking law definitions are applied in this context, these types of central entities may be viewed as engaging in activity that is "financial in nature," even with respect to physical transactions. Hence, some energy companies may be precluded from electing the end-user clearing exception for swaps used to hedge their commercial risks and be subject to additional regulations applicable to financial entities. Importantly, two similar energy companies may be treated differently if, for example, one entity uses a central affiliate to conduct these activities and another conducts the same activity in an entity that also owns physical assets or that has subsidiaries that own physical assets. Accordingly, Congress should amend the definition of "financial entity" to ensure that commercial end-users are not inadvertently regulated as "financial entities."

Inter-affiliate Transactions

Currently, the CFTC's rules and proposed rules generally treat inter-affiliate swaps like any other swap. Hence, companies must, under certain circumstances, report swaps between majority-owned affiliates and must submit such swaps to central clearing unless the end-user hedging exception applies or complex criteria for the inter-affiliate clearing exemption are met. In the absence of a more expansive clearing exemption for inter-affiliate trades, the costs of

clearing likely would deter most market participants from entering into inter-affiliate transactions and could create more risk for clearinghouses. For example, without an exemption, additional affiliates in a corporate family would need to become clearing members or open accounts with a Futures Commission Merchant, and all affiliates would need to develop and implement redundant risk management procedures and trade processing services, such as e-confirm.

The CFTC has provided some relief in the form of no-action letters. However, in many circumstances, these no-action letters do not provide adequate relief and frequently cause more confusion and uncertainty among end-users. EEI supports bipartisan legislation to clarify the requirements placed on inter-affiliate transactions. The Inter-Affiliate Swap Clarification Act (H.R. 677), which seeks to clarify a number of these requirements, has been introduced by Rep. Steve Stivers (R-OH) in the House.

Finally, for the reasons enumerated in the testimony of the American Gas Association, we agree that options and forward contracts that are intended to be physically settled or contain volumetric optionality should be excluded from the definition of a swap.

Conclusion

Thank you for your leadership and ongoing interest in the issues surrounding implementation of the Dodd-Frank Act and their impact on commercial end-users. We appreciate your role in helping to ensure that electric utilities and energy suppliers can continue to use over-the-counter derivatives in a cost-effective manner to help protect our electricity consumers from volatile wholesale energy commodity prices.

Again, I appreciate the opportunity to testify and would be happy to answer any questions.

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 wholesale market issues before the Federal Energy Regulatory Commission. Also, he leads the industry's advocacy on Dodd-Frank Act issues 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.

April 2012

Committee on Agriculture
U.S. House of Representatives
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Name: Richard E. McMahon, Jr.

Organization you represent (if any): Edison Electric Institute

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Source:_____ **Amount:**_____

Source:_____ **Amount:**_____

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