American
Public Power
Association

Ph: 202.467.2900
Fax: 202.467.2910
www.APPAnet.org

1875 Connecticut Avenue, NW
Suite 1200
Washington, DC 20009-5715

STATEMENT OF TERRANCE NAULTY
GENERAL MANAGER & CEO
OWENSBORO MUNICIPAL UTILITIES
BEFORE THE

HOUSE COMMITTEE ON AGRICULTURE

HEARING ON EXAMANING LEGISLATIVE IMPROVEMENTS TO TITLE VII OF THE DODD-FRANK ACT

March 14, 2013

Mr. Chairman and Members of the Committee, I am Terry Naulty, General Manager and CEO of Owensboro Municipal Utilities (OMU) testifying today on behalf of my utility and the American Public Power Association (APPA) [1].

OMU is located in Owensboro, Kentucky, proudly serving an estimated 26,100 electric customers and 24,739 water users, including both residential and commercial accounts. The sole purpose of our business is to ensure that the electric and water and sewer demands of our customers are met, both today and for generations to come.

OMU is a member of APPA, the national service organization representing the interests of over 2,000 municipal and other state- and locally-owned, not-for-profit electric utilities throughout the United States (all but Hawaii). Collectively, these government-owned utilities deliver electricity to one of every seven electricity customers in the United States (approximately 47 million people), serving some of the nation's largest cities. However, the vast majority of APPA's members serve communities with populations of 10,000 people or less.

I appear today to speak in favor of H.R. 1038, the Public Power Risk Management Act of 2013, legislation that will allow my utility, and other government-owned power and natural gas utilities, to hedge against price risks on a level playing field with all other utilities. This legislation will protect our customers from unnecessary price increases.

Public Power Utilities and the Dodd-Frank Act

In the wake of the 2007 and 2008 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) required the Commodity Futures Trading

[1] "Public Power" is not defined in the law, but generally refers to government-owned utilities. This is distinguished from a "public utility" which generally refers to an investor-owned utility, as under the Public Utility Holding Company Act of 1935 and the Federal Power Act.

Commission (CFTC) to provide comprehensive regulations for the swaps marketplace. Specifically, the Dodd-Frank Act requires swap dealers and major swap participants to register with the CFTC and meet capital, margin, and reporting and recordkeeping requirements, as well as to comply with rigorous business conduct and documentation standards.

The Dodd-Frank Act provides additional standards for swap dealers or major swap participants advising or entering into swaps with government-owned utilities and other government entities (referred to under the statute as "special entities"). For a swap dealer acting as an advisor to a special entity, the law states that the swap dealer shall have a duty to act in the best interests of the special entity.[2] For swap dealers or major swap participants entering into swaps with special entities, the law states that these dealers and swap participants must comply with rules set by the CFTC requiring special entities to have a qualified independent representative before trading with a swap dealer or major swap participant.[3]

Also, in part to address concerns that the legislation would force too many entities into this more stringent regime, the Dodd-Frank Act included a "*de minimis* exception" to the definition of a swap dealer.[4]

APPA supports the goals of the Dodd-Frank Act and has worked closely with the CFTC and other interested parties to improve its implementation, particularly related to regulations affecting "end users" – that is, nonfinancial parties that enter into swaps to hedge or mitigate their commercial risks. OMU and other APPA members are "end users." Dozens of new regulations affect our members' businesses, and APPA and a coalition of not-for-profit electric utilities have submitted formal comments on 17 specific regulations from the CFTC and Securities and Exchange Commission (SEC) related to implementation of the Dodd-Frank Act.

One such instance is the rule defining swap-dealer,[5] which became final on July 23, 2012. Swap dealer registration regulations went into effect on October 12, 2012, at which time entities were required to begin counting their "swap dealing" activities. Those with dealing activity in excess of the *de minimis* thresholds had to register as swap dealers by December 31, 2012. However, the CFTC issued several no-action letters that allow swap dealers to delay their compliance with most of the business conduct and documentation standards until July 2013.

As written, the swap-dealer definition will substantially hinder government-owned utilities' ability to hedge against operational risks. Just like OMU, these utilities have no shareholders, so the costs imposed by this regulatory decision will be borne by only one group: our residential and business customers.

In December 2010, the CFTC jointly with the SEC issued a proposed rule to define the term "swap dealer," including (as required by the statute) an exception from the swap-dealer designation for those entities that engage in a *de minimis* quantity of swap dealing.

---

[2] 7 USC § 6s(h)(4).
[3] 7 USC § 6s(h)(5).
[4] 7 USC § 1a(49)(D).
[5] CFTC Regulation 1.3(ggg)(4); see 77 Fed. Reg. 30596, at 30744.

In the proposed rule, the CFTC proposed two separate *de minimis* thresholds relating to the dollar quantity of swaps: $100 million annually for an entity's total swap-dealing activity; and, $25 million annually for an entity's swap-dealing activity with special entities, including, as noted above, public power, public gas, and federal utilities (government-owned utilities).

In February 2011, the Not-For-Profit Electric End User Group (NFP EEU)—which includes APPA—filed comments on the proposed swap dealer rule. The comments recommended that the CFTC substantially increase the *de minimis* threshold both for total swaps and for swaps with special entities.

A final swap dealer rule was approved by the CFTC on April 18, 2012, and was published in the *Federal Register* on May 23, 2012. The final rule greatly increased the overall *de minimis* threshold from the proposed rule, raising it from $100 million to $3 billion. During an initial phase-in period, this threshold will be $8 billion. But, the final rule did <u>not</u> change the proposed rule's $25 million sub-threshold for swap-dealing activities with special entities. Thus, the disparity between the two thresholds is now substantially greater. This $25 million sub-threshold is smaller still when you consider that it is the aggregate of a swap partner's transactions with <u>all</u> special entities during any 12-month period.[6]

As a result, nonfinancial entities (such as natural gas producers, independent generators, and investor-owned utility companies) that do not want to be swap dealers will severely limit their swap-dealing activities with government-owned utilities to avoid exceeding the $25 million threshold.

<u>Why Hedging Is Necessary</u>

Government-owned utilities depend on nonfinancial commodity transactions, trade options, and "swaps," as well as the futures markets, to hedge commercial risks that arise from their utility facilities, operations, and public service obligations. Together, nonfinancial commodity markets play a central role in the ability of government-owned utilities to secure electric energy, fuel for generation, and natural gas supplies for delivery to consumers at reasonable and stable prices.

Specifically, many government-owned utilities purchase firm electric energy, fuel and natural gas supplies in the physical delivery markets (in the "cash" or "spot" or "forward" markets) at prevailing and fluctuating market prices, and enter into bilateral, financially-settled nonfinancial commodity swaps with customized terms to hedge the unique operational risks to which many government-owned utilities are subject. Additionally, many government-owned utilities have traditionally used the swaps and futures products to hedge their excess electrical generation capacity, thus providing revenue and rate certainty to their customer/owners. In hedging, mitigating or managing the commercial risks of their utility facilities' operations or public service obligations, government-owned utilities are engaged in commercial risk management

[6] By way of reference a single, one-year 100 MW swap could have a roughly $25 million notional value. One-hundred MWs of power is enough to serve the average demand of approximately 75,000 residential customers.

activities that are no different from the operations-related hedging of an investor-owned utility or an electric cooperative located in the same geographic region.

Why Nonfinancial Counterparties Are Necessary

Electric power touches virtually every home and business in the United States. This near universality gives a false appearance of homogeneity. It is important to remember that what is being delivered, either power or fuel to provide power, is a physical commodity, e.g., electricity, coal, natural gas, and the like. Ownership of a stock can be transferred coast to coast with a click of a button, but electricity must be delivered to the place it is to be used. Further, storage of electricity for future use, unlike other commodities such as gasoline, grain, coffee, etc. is not currently viable and thus electricity must be produced at the time it is used.

Each regional geographic market has a somewhat different set of demands driven by climate, weather, population, and industrial activity, among other factors. Each regional geographic market also has a somewhat different group of financial entity counterparties and nonfinancial entity counterparties available to meet these demands and thus able to enter into utility operations-related swaps needed for hedging price and supply risks. For example, a large merchant electric generation station in western Alabama might be available as a nonfinancial counterparty for a swap transaction to provide electricity to a specific site in Alabama. But that same entity would not necessarily be able to offer the electricity in Oregon, and so would not be able to help an Oregon-based utility hedge its risks. Further, owners of electrical generation facilities and distribution utilities, whether investor-owned utilities, cooperative utilities, merchant generation companies, or government-owned utilities, operate in their geographical proximity and as they balance their generation to meet changing demands on an hour-to-hour basis are the most likely trading counterparties in their regions. These regional market participants, unlike financial entities, have a vested interest in maintaining the reliability of the grid and ensuring that sufficient liquidity exists to manage their operations.

In Regional Transmission Organization (RTO) markets such as PJM and MISO, the market design is such that using financial swaps and futures contracts to manage risk is now the standard. This is because the RTO markets provide unlimited physical liquidity in the day-ahead and real-time markets to ensure reliability of service, and thus converting a financial price hedge to a physically delivered product in real-time is, by design, the way these RTO markets function.

Because there are a limited number of counterparties for any particular operations-related swap sought by a utility, each financial or nonfinancial swap counterparty brings important market liquidity and diversity. The greater the number of counterparties, the greater the price competition. Conversely, reduced price competition necessarily increases prices.

OMU and the Special Entity Sub-Threshold

I would like to illustrate these points with examples from my utility's perspective.

OMU has been providing electric service to its community since 1900. OMU owns a coal-fired power plant and has surplus power that it sells into the wholesale market in order to offset transferring the fixed costs associated with such surplus capacity to its retail customers. OMU uses financial transactions in the forward market to lock in the best price for these sales, to reduce its market risk, to stabilize revenue, and, most importantly, to provide rate certainty to its customers/owners.

OMU's approach has been to enter into enabling agreements with the most active physical and financial traders with solid credit ratings in our region. Prior to the establishment of the special entity rule *de minimis* threshold, this short list of counterparties allowed OMU to accomplish the hedging necessary while spreading the credit risk among counterparties. Because OMU has been pragmatic in choosing its trading counterparties, limiting the population to those entities with superior credit ratings, the negotiated collateral agreements do not require OMU to post collateral unless it exceeds a specified credit limit.

However, since the CFTC's implementation of the special entity *de minimis* threshold, two of OMU's three largest counterparties, which are both utility-affiliated trading companies and not "swap dealers," are no longer willing to do business with OMU. They cite the compliance risk and lack of internal systems to keep track of special entity transactions and ensure that they do not exceed the threshold. This compliance risk is not due solely to their business with OMU, but also because they do business with multiple "special entities" across the country and in our region.

This means that swap dealers are the only entities willing to enter into swap transactions with OMU. Since OMU's ability to hedge via swaps bilaterally with physical generation owners in our region has been greatly diminished, OMU has seen the bid-ask spread from swap dealer counterparties widen.

Consequently, OMU has been forced to move most of its hedging transactions to the ICE trading platform, which offer futures contracts. This means that OMU can no longer take advantage of its negotiated collateral agreements, and instead must comply with initial and maintenance margin requirements to support its hedging activities. As a result, OMU's board of directors required OMU to establish reserves of $10 million to ensure that the utility can meet margin calls associated with its hedged positions. If this $10 million in incremental cash reserves were funded from our customers/owners, the result would be an approximate 10 percent rate increase.

As noted above, there is a great deal of heterogeneity among APPA members, including in the use of hedging. Some make substantial use of hedging, and others do not. Likewise, of APPA members who do make use of hedging, a recent informal survey of members showed great diversity in terms of the volume of hedging and the extent to which members relied on nonfinancial entities. Also, smaller members who are unlikely to hedge may still be affected, if they buy power from larger members who do.

The CFTC has said that it retained the $25 million threshold in light of the special protections that the Dodd-Frank Act affords to special entities. However, the statute does not require—even mention—special protections for special entities in regard to the swap dealer definition. As noted above, the law imposes requirements on swap dealers and major swap participants advising or entering into swaps with special entities. Nowhere does the law mention deeming a participant to be a swap dealer solely based on its volume of swaps with government-owned entities.

Government-owned utilities understand the operations-related swap transactions they use to manage their commercial risks and do not need the special protections provided by the $25 million sub-threshold. In fact, and ironically, these "protections" are likely to limit the ability of these utilities to hedge operational and price risks rather than to protect these utilities and their customers from risk.

Government-Owned Utilities' Petition for Rulemaking

On July 12, 2012, APPA, the Large Public Power Council (LPPC), the American Public Gas Association (APGA), the Transmission Access Policy Study Group (TAPS), and the Bonneville Power Administration (BPA), filed with the CFTC a "Petition for Rulemaking to Amend CFTC Regulation 1.3(ggg)(4)." The petition requests that the CFTC amend its swap-dealer rule to exclude utility special entities' utility operations-related swap transactions from counting towards the special-entity threshold. This amendment to the swap-dealer rule would allow a producer, utility company, or other nonfinancial entity to enter into energy swaps with government-owned utilities without danger of being required to register as a "swap dealer" solely because of its dealings with government-owned utilities.

Specifically, the petition asks for a narrow exclusion:

- A government-owned utility's swaps related to utility operations would not count towards the special entity *de minimis* threshold, but would count towards the total *de minimis* threshold.

- Utility operations-related swaps are those entered into to hedge commercial risks intrinsically related to the utility's electric or natural gas facilities or operations, or to the utility's supply of natural gas or electricity to other utility special entities, or to its public service obligations to deliver electric energy or natural gas service to utility customers. For example, these would include swap transactions related to the generation, production, purchase, sale, or transportation of electric energy or natural gas, or related to fuel supply of electric generating facilities.

- Utility operations-related swaps do not include interest rate swaps. Those swaps would remain subject to the $25 million special entity sub-threshold.

CFTC "No Action" Letter

CFTC released on October 12, 2012 a no-action letter relating to the $25 million special entity sub-threshold. The letter allows a counterparty to deal in up to $800 million in swaps with government-owned utilities without being required to register as a swap dealer. As the CFTC explained in that letter, the $800 million is derived from a comment letter endorsed by the NFP EEU group suggesting that the special entity sub-threshold be set at 1/10th that of the overall swap dealer threshold.

The no-action letter, however, also included a number of additional limitations on a counterparty wishing to take advantage of the relief provided by the letter. Specifically, under the terms of the CFTC's no-action letter, the $800 million threshold applies only:

- If the special entity that is a party to the swap is using the swap to hedge a "physical position;"

- If the counterparty is not a "financial entity" as defined in the Commodity Exchange Act;

- If the swap is related to an exempt commodity in which both parties transact as part of the "normal course of their physical energy businesses;" and

- If a counterparty wanting to take advantage of the relief provided by the no-action letter files with the CFTC a notice that it is making use of the relief and provides, by December 31 (and quarterly thereafter), a list of each utility special entity with which it has entered into swaps and the total gross notional value of those swaps.

Certain counterparties have expressed concerns over one or more of the conditions imposed in the no-action letter, but it could also be that counterparties, in general, are not willing to spend the time and money to create a separate compliance process and adjust their policies and procedures in order to facilitate transactions with the small segment of any particular regional market that utility special entities represent. This is especially likely now as counterparties are focused on implementing compliance programs dealing with the whole range of Dodd-Frank requirements. Finally, there is the overarching issue that the no-action letter, by definition, is temporary and can be revised or revoked without any of the steps of a formal rulemaking process.

Whatever the reason, the no-action letter has failed to provide nonfinancial counterparties with the assurances they need to enter into swap transactions with our members.

A November 19, 2012, letter to the CFTC explaining this outcome has failed to produce any further action from the CFTC, and some commissioners have indicated that we should turn to Congress to achieve the remedy we are seeking.

The Public Power Risk Management Act

On March 11, 2013, the Public Power Risk Manage Act of 2013 (H.R. 1038) was introduced by Congressman Doug LaMalfa (R-CA), a member of this committee, with fellow committee members Jim Costa (D-CA), Jeff Denham (R-CA), and John Garamendi (D-CA), along with House Financial Services Committee member Blaine Luetkemeyer (R-MO)

The legislation largely mirrors the intent and effect of the NFP EEU petition to the CFTC, providing narrowly targeted relief for operations-related swaps for government-owned utilities. Specifically, the legislation would provide that the CFTC, in making a determination to exempt a swap dealer under the *de minimis* exception, shall treat a utility operations-related swap with a utility special entity the same as a utility operations-related swaps with any entity that is not a special entity.

Under the current threshold/sub-threshold regulatory regime adopted by the CFTC, this would mean that utility operations-related swaps with a government-owned power or natural gas utility would not be counted in calculating whether swap dealing activity exceeded the $25 million special entity *de minimis* threshold, but would be counted in calculating whether swap dealing activity exceeded the $8 billion *de minimis* threshold.

The legislation carefully defines which entities would qualify as a "utility special entity." It also specifically defines the types of swaps that could and could not be considered a "utility operations-related swap." For example, the legislation specifically prohibits interest, credit, equity, and currency swaps from being considered as a utility operations-related swap. Likewise, except in relation to their use as a fuel, commodity swaps in metal, agricultural, crude oil, or gasoline would not qualify either.

Finally, the legislation also confirms that utility operations-related swaps are fully subject to swap reporting requirements.

When implemented, this legislation should provide the certainty to nonfinancial entities that they can enter into swap transactions with government-owned utilities without fear of being deemed a swap dealer. It truly levels the playing field. And, it does nothing to otherwise alter the CFTC's implementation of the Dodd-Frank Act.

We wish the legislation were not necessary, but given the realities we face and the ongoing damage being done under the current rules, we urgently request the members of this committee to support this narrow legislative fix.

Finally, because of our experience with the $25 million sub-threshold, we are intrigued by another bipartisan bill recently introduced in the House. The legislation, H.R. 1003, would require the CFTC to quantify the costs and benefits of future regulations and orders. Sadly, the legislation is prospective, but we believe that had such an analysis been made, it could have prevented the turmoil currently being caused by the $25 million special entity sub-threshold.

Conclusion

In conclusion, the protections the CFTC is trying to afford through the $25 million special entity sub-threshold are not needed for utility operations-related swaps entered into by government-owned utilities.

Government-owned utilities are well-versed in the markets in which they are hedging their risks and rely on these swaps solely to manage price and operational risks.

More importantly, the assumption that financial firms will be able to replace all the swaps offered currently by our nonfinancial swap partners reflects a dangerous misunderstanding of how electricity is delivered and an indifference to the price Wall Street will impose in the absence of adequate competition.

In sum, a failure to allow the narrow relief provided under the Public Power Risk Management Act will limit our members' ability to hedge against risks and lead to increased risk and costs to the ratepayers they serve.

Thank you again for this opportunity to testify, and I would be more than happy to answer any questions you might have.

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, 2010.

Name: __Terrance P. Naulty____

Organization you represent (if any): ____Owensboro Municipal Utilities______

____

1. Please list any federal grants or contracts (including subgrants and subcontracts) <u>you</u> have received since October 1, 2010, 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, 2010, as well as the source and the amount of each grant or contract:

Source:__FEMA #-1802-DR-KY_______________ Amount:__$162,512.77_____________

Source:____ Amount:_______________

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

Signature:____

* Rule XI, clause 2(g)(5) 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.

Committee on Agriculture
U.S. House of Representatives
Information Required From Nongovernmental Witnesses

House rules require nongovernmental witnesses to provide their resume or biographical sketch prior to testifying. If you do not have a resume or biographical sketch available, please complete this form.

1. Name: ___**Terrance P. Naulty**___

2. Organization you represent: ___**Owensboro Municipal Utilities and the American Public Power Association**___

3. Please list any occupational, employment, or work-related experience you have which add to your qualification to provide testimony before the Committee: ____ _**See attached biographical sketch**

4. Please list any special training, education, or professional experience you have which add to your qualifications to provide testimony before the Committee: ____ **a) 15 years of trading and marketing of electric and natural gas related products for both utility affiliated trading companies and financial entities. b) Former Managing Director for a major international bank where I led the structuring and analytical aspects of structured power and natural gas supply agreements to investor owned, cooperative and municipal customers. Work involved using and developing complex derivatives, cross commodity hedging techniques in multiple structured RTO and traditional markets to help customers manager commodity risks.**

5. If you are appearing on behalf of an organization, please list the capacity in which you are representing that organization, including any offices or elected positions you hold: __**General Manager & CEO – Owensboro Municipal Utilities Member – American Public Power Association**

PLEASE ATTACH THIS FORM OR YOUR BIOGRAPHY TO EACH COPY OF TESTIMONY.

Terrance Naulty was appointed General Manager of Owensboro Municipal Utilities on August 16, 2012. He is responsible for providing leadership to the utility in supplying reliable, affordable and environmentally responsible electric, water and telecommunications to the city of Owensboro Kentucky. Prior to his appointment as General Manager he was Director of Power Marketing at OMU.

Mr. Naulty has 30 years of experience in the electric power business and has held many leadership and senior commercial positions. Prior to OMU Mr. Naulty founded and was the Managing Partner at Liberty Green Renewables, a renewable energy development company which he sold to a major international infrastructure fund in 2010. His other positions included Managing Director at Fortis Energy Marketing and Trading where he was responsible for North American power origination and structuring, Senior Vice President of Origination and Structuring at Cinergy (now Duke Energy), and Vice President of Origination at Reliant Energy. Early in his career, Mr. Naulty worked for Louisville Gas and Electric in plant engineering positions and as Director of Environmental Affairs. For eight years he was a practicing environmental engineer and Sr. Project Manager with Radian Corporation where he specialized in environmental permitting and air pollution control equipment design and optimization.

Mr. Naulty has a bachelor of science in Environmental Engineering from Purdue University and is a professional engineer. He attended Indiana University's Kelly School of Business. He is a member of the Board of Directors of the Greater Owensboro Economic Development Commission.