Statement of Lael E. Campbell
On behalf of the Edison Electric Institute
On "Reauthorizing the CFTC: End-User Views"

Before the Subcommittee on Commodity Exchanges, Energy, and Credit
Committee on Agriculture
U.S. House of Representatives

Tuesday, March 24, 2015

Introduction

Chairman Scott, Ranking Member Scott and Members of the Subcommittee, thank you for the opportunity to discuss the views of end-users in reauthorizing the Commodity Futures Trading Commission (CFTC) through the Commodity Exchange Act Reauthorization.

I am Lael Campbell, Director of Regulatory and Government Affairs with Exelon Corporation, testifying on behalf of the Edison Electric Institute (EEI). EEI is the association of U.S. investor-owned electric utilities, international affiliates and industry associates worldwide. Our industry directly employs more than 500,000 workers, and EEI's investor-owned electric utility members serve nearly 70 percent of America's industries, businesses and consumers.

Headquartered in Chicago, Exelon conducts business in 48 states, the District of Columbia, and Canada. The company is one of the largest competitive U.S. power generators, with power plants in 19 states. Exelon owns or controls approximately 35,000 megawatts of generation capacity, is the nation's largest nuclear operator, and one of the nation's largest wind energy generators, comprising one of the nation's cleanest and lowest-cost power generation fleets. Exelon also owns three utilities, which reliably deliver electricity and natural gas to more than 7.8 million utility customers in central Maryland (Baltimore Gas & Electric Company), northern Illinois (Commonwealth Edison), and southeastern Pennsylvania (Philadelphia Electric Company or PECO). Finally, our Constellation-branded family of competitive retail businesses serves more than 2.5 million residential, public sector, and business customers with electricity, gas, energy management services and distributed generation, including more than two-thirds of the Fortune 100.

The electric power sector is a $910-billion industry and is the most capital-intensive industry in the United States. It is projected to spend approximately $90 billion a year, on average, for major transmission, distribution and smart grid upgrades; cybersecurity measures; new, cleaner generating capacity; and environmental and energy-efficiency improvements. The electric power industry represents approximately 2 percent of our nation's real gross domestic product.

EEI members are non-financial entities that primarily participate in the physical commodity market and rely on swaps and futures contracts to hedge and mitigate their commercial risk. The goal of our member companies is to provide their consumers 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 consumers. The derivatives market has proven to be an extremely effective tool in insulating our consumers 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 federal agencies, including the CFTC, as they work their way through the implementation process to ensure that the congressional intent of protecting non-financial end-users from unnecessarily burdensome impacts of financial market reform 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.

We support the Dodd-Frank Act's primary goals of protecting the financial system against systemic risk and increasing transparency in derivatives markets. However, 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. Last year, through the bipartisan leadership of Congressmen Lucas, Peterson, Conaway, and Scott, and all the members of this Committee, H.R. 4413 – the Customer Protection and End User Relief Act - was passed out of the House by a bipartisan vote of 265-144. This legislation contained a number of those minor adjustments we believed could have helped to ensure that the end-user community was not inadvertently swept into regulations that were not intended to cover us.

As this Subcommittee and Congress again examine possible modifications to the Commodity Exchange Act, we hope we can build upon the successes of last year's legislation and ask that you again consider the following issues:

Volumetric Optionality

One of the key concerns for end-users is an interpretation of the definition of a "swap" that includes within that definition certain physically-delivered contracts entered into only by physical market participants. EEI members believe that regardless of whether the non-financial commodity transaction at issue is a forward contract with "embedded optionality" or a "standalone" commodity trade option, if the transaction at inception is intended for physical

settlement, the transaction is excluded from the term "swap" for all regulatory purposes by the Commodity Exchange Act (CEA 1a(47)(B)(ii)). The predominant feature of these contracts, as contemplated by the parties at the time the contract was entered into, is actual delivery; the embedded optionality does not undermine the overall nature of these contracts as forward contracts. As such, we respectfully urge the Committee to adopt a provision similar to that contained in last year's reauthorization bill that clarified that all sales of a non-financial commodity for deferred shipment or delivery, so long as the transaction is intended to be physically settled at the time it is entered into, is a not a swap regardless of whether it contains an embedded option.

Trade options and physically delivered forward transactions with embedded optionality serve the purpose of providing the option holder flexibility to respond to changing supply and demand circumstances, such as ensuring delivery of fuel to a generation plant when fuel is needed. EEI members create a physical supply portfolio designed so that they can provide electric service to their retail consumers at low rates. Contracts for physical delivery of commodities such as electricity or natural gas are vital to the business of EEI members. Treating every-day transactions that are used to manage operational and physical supply risks as "swaps" has significantly, and unnecessarily, increased end-user regulatory and compliance costs associated with these transactions, with no recognizable offsetting public benefit.

De Minimis Level

The CFTC issued a proposed rule on the swap dealer 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, absent an affirmative CFTC action, the de minimis threshold is scheduled to be reduced automatically to $3 billion at the end of 2017.

End-users are concerned that a lower swap dealer de minimis threshold will cause companies to cease transacting in swaps with other end-users because the extra costs and burdens associated with registration as a swap dealer are not sustainable for most commercial energy companies. This in turn will lead to fewer hedging counterparties available in the market, making hedging and risk management all the more difficult and costly for end-users. This concern is imminent, despite the 2017 date for the drop in the threshold. Because the de minimis measurement is over a 1-year period, end users will have to make these critical business decisions and adjust their activities beginning in 2016.

A lower swap dealer de minimis level would lead to further consolidation of the swap business to a handful of registered swap dealers, mostly large Wall Street banks whose primary business is dealing in swaps. This threat is not purely hypothetical: when the CFTC initially

proposed a lower dealing threshold for counterparties of government and municipal utilities ("utility special entities"), those utility special entities found that liquidity rapidly disappeared and the number of available counterparties diminished significantly. Eventually the CFTC acknowledged the negative impact this low threshold had on the ability of utility special entities to hedge their risk with other commercial counterparties, and the CFTC increased the de minimis level for energy swaps with these special entities to the same $8 billion dollar threshold that applies to all swaps. This example highlights the important role the end-user to end-user swap market plays in managing risk in the energy space. It is likely that a lower de minimis level would result in an impact similar to what was seen for utility special entities, but this time the impact will be felt by all commercial end-users that use swaps to manage risk, not just municipalities.

As such, EEI opposes this dramatic reduction in the de minimis threshold that is set to take place without any deliberate CFTC action. 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. We respectfully urge the Committee to adopt a provision similar to that contained in last year's reauthorization bill that would prevent the de minimis level from dropping without a new rulemaking by the CFTC.

Requiring that a rulemaking process be in place rather than an automatic reduction does not take any discretion away from the CFTC but will help ensure that stakeholders have input into the appropriate level for the threshold. Absent these procedural changes, we are concerned a deep automatic reduction in the de minimis level could hinder the ability of end-users to hedge market risk while imposing unnecessary costs that eventually will be borne by consumers.

***Bona fide* Hedging**

The dynamic and complex nature of energy markets, in particular electricity markets, demands flexibility to those charged with managing risk in these markets. EEI is concerned that the CFTC's Proposed Position Limits Rule unduly limits the hedging activities of commercial end-users by precluding long-established and well-accepted hedging practices. The question for the Commission is what constitutes excessive speculation, as some amount of speculation is needed to maintain liquidity in the markets. What constitutes excessive speculation may also depend on the market as commodity prices are inherently volatile and are dependent on a number of factors such as demand for the commodity, customer demand, weather, and mechanical outages, among others. If applied inappropriately, position limits could have the effect of limiting or constraining risk. Unreasonable and unsupported position limits stifle market liquidity, negatively impact price transparency, and increase the cost of hedging. Any increase in hedging costs ultimately results in an increase of the price our consumers pay for the energy we provide. The CFTC has not made fact-based findings on the need for position limits.

EEI is concerned that the Proposed Rule discounts the importance of long-established hedging practices that have been used by EEI members and other commercial end-users by limiting traditional practices such as hedging on a portfolio basis, anticipatory hedging, cross–commodity hedging and hedging of unfixed price risk.

Gross Hedging

The proposed position limits rule implies that an entity has to net all of its physical exposures enterprise wide in order to qualify for bona fide hedge status, and that the entity cannot take into account exposures on a legal entity or portfolio basis. Portfolio-based risk management is a common and long-standing commercial practice of producers, processors, merchants and commercial users of commodities and commodity byproducts. This is especially important to EEI members as energy markets are regional in nature. As a result, many utilities and independent power producers manage portfolios of risk by region. In one region, a power producer may be long physical generation, and in another region it may be short physical power (i.e., it has more load or demand for power than it has generation). A power producer's long physical position in one region should not limit its ability to hedge its short physical position in another region. The regional nature of the electric power industry also means that hedging on a net basis would be unworkable, requiring costly new technology systems to be built around more rigid, commercially impractical hedging protocols that prevent dynamic risk management in response to rapidly changing market conditions. Moreover, forcing end-users to net positions between regions, or business units, that may have limited commercial relationship with each other, will increase risk, not decrease risk.

Cross-Commodity Hedging

Under the Proposed Rule, the CFTC would only presume bona fide hedging status for a cross-commodity hedge (e.g. hedging electricity price risk with a natural gas derivative) where there is an appropriate quantitative relationship "when the correlation, between first differences or returns in daily spot price series for the target commodity and the price series for the commodity underlying the derivative contract is at least 0.80 for a time period of at least 36 months." This quantitative requirement ignores the relationship between the price of the fuel used to generate electricity and the price of electricity, and the long-standing and accepted risk management practice of utilities and other power generators to use natural gas Referenced Contracts and other fuel-based derivatives to hedge the price risk associated with their electricity production.

Many market participants hedge long-term electricity price exposure with natural gas derivatives contracts because there is insufficient liquidity in deferred month electricity derivatives contracts. Therefore, requiring the proposed quantitative correlation in outer months would eliminate all available tools for hedging at illiquid locations which, in turn, would result in

higher risks for market participants and higher costs for consumers. Due to long-established risk manage practices using cross-commodity hedges, EEI would urge the Commission to give discretion to this widely recognized risk management practices used in the industry.

Anticipatory Hedging

There are legitimate commercial reasons for commercial end-users to engage in anticipatory hedging, and a final position limits rule should not restrict this activity. For example, an EEI member should be permitted to hedge a binding and irrevocable bid in a state-administered auction for suppliers to provide electricity to utility consumers. Taking away suppliers' ability to hedge their irrevocable bids in the period between making the bid and the auction results being approved by the state utility commission will result in the risk of a market move during this interim period being factored into the bid price, which will raise prices for consumers.

Unfixed Price Risk

EEI members are concerned that the proposed position limits rule only provides bona fide hedge treatment for "unfilled" anticipated fuel requirements for a generator. However, it is common in the electricity industry for a generator to "fill" its fuel requirements with an unfixed price fuel supply contract. This contract ensures the generator will have the physical fuel supply, but still leaves the generator exposed to unfixed or variable price risk. Bona fide hedging treatment should be provided to generators (or other commercial market participants) for transactions that hedge or "fix" their market exposure to unfixed price risk, even if their anticipated fuel requirements are "filled". The fact that such a common transaction does not receive bona fide hedge treatment under the Proposed Position Limits rule further supports the need for the Committee to require the CFTC to recognize commonly accepted risk management practices of end-users.

EEI members follow documented risk management procedures to ensure that hedging transactions are designed to manage the risks incurred in their commercial operations. In addition, since the hedges are based on physical commodities, the value of the hedge changes as the market moves. Many EEI members have front office commercial operations personnel, supported by middle office risk management policies and back office derivative accounting processes, who have the responsibility of managing complex and dynamic commercial operations that incur risks from volatile commodity prices. If a hedge is not effective, these controls will identify it and require a change. As such, the CFTC should be required to continue to recognize the industry's risk mitigation practices, and the Committee should not permit the CFTC to further restrict what constitutes a bona fide hedge.

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. 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.

In contrast to market-facing swap transactions, swaps between majority-owned affiliates are typically entered into for operational and administrative efficiency in managing a commercial enterprise. The CFTC has provided some relief in the form of no-action letters, but these no-action letters do not provide end-users with adequate certainty. We ask that the Committee provide this certainty by permanently exempting swap transactions between majority-owned affiliates from these unnecessarily burdensome reporting and clearing obligations.

1.35

CFTC Regulation 1.35(a) imposes broad recordkeeping requirements on certain market participants, including "members" exchanges (DCMs and SEFs). EEI appreciates the Commission's proposal to reduce some of the recordkeeping burden imposed by Commission Regulation 1.35(a) on commercial end-users. However, while the Commission's intentions are well-placed, the approach in the Commission's Proposed Rule still leaves uncertainty and costs that are not necessary to impose on persons that are not registered with the Commission and who are only executing trades for their own account. For example, although unregistered members of a DCM or SEF are now exempted from the requirement to retain text messages, unregistered members must still retain written and electronic records of pre-trade communications. As a result of these unnecessary burdens, end-users may opt not to become members of a DCM or SEF, despite the policy goal of the Dodd-Frank Act to encourage more on-exchange activity. For this same reason end-users may also forgo a direct clearing membership arrangement, despite growing global concerns with rising costs of clearing that a direct clearing membership would help mitigate.

EEI respectfully requests that the Committee clearly exclude from the application of Regulation 1.35 commercial end-users that are not registered with the Commission and who are not transacting on behalf of consumers.

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."

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 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.