

From a joint statement by 13 electric and natural gas associations (including Edison Electric Institute) to the U.S. House Financial Services Committee on proposed reform of over-the-counter derivatives markets. The committee approved the Over-the-Counter Derivatives Markets Act of 2009 for House debate on October 15.

We use over-the-counter (OTC) derivatives extensively to manage commodity price risk for electricity, natural gas, and other fuels, as well as to contain risk-related costs when financing energy infrastructure. OTC contracts help insulate our customers from excessive price volatility....

[We] support the goals of the Administration and Congress to increase regulation as well as improve transparency and stability in OTC derivatives markets. When discussing any increased regulation of exchange and OTC markets, we believe there should be an appropriate balance between establishing market oversight rules that allow for a broad use of market-based risk management tools while providing regulators with the ability to establish a high level of transparency and the tools needed to protect consumers against market manipulation and systemic risk.

[E]ffective OTC derivatives reform should promote

- greater regulatory oversight and transparency of OTC derivatives through increased financial reporting and authority to the Commodity Futures Trading Commission (CFTC) to prevent manipulation of the derivatives markets;
- clearing of standardized derivatives or large financial dealers, where appropriate, through regulated central counterparties to reduce systemic risk and bring additional transparency... regarding pricing, volume, and risk; and
- the harmonization and clear delineation of regulatory authorities and functions among the Securities and Exchange Commission, CFTC, the Federal Energy Regulatory Commission,

POWER AND GAS NEED OTC TRADING

Excerpts from a joint statement to the House Financial Services Commission.

and other federal agencies to ensure similar products are governed by similar standards. Accordingly, such harmonization should also work to minimize the burden and cost of compliance with regulatory oversight.

[H]owever, we are concerned with certain aspects of proposals to address oversight of OTC energy markets.

Exchange Trading

Most notably, we oppose mandates that all derivatives transactions be centrally cleared or executed on exchanges. Such a requirement would greatly reduce the ability of companies to find the customized derivative products they need to manage their risks because clearinghouses and exchanges require a high level of margin and collateral for the products traded. Such customization is necessary for everything from specific delivery points in electricity contracts to quantities of natural gas. Without the ability to use these customized transactions, energy suppliers would be severely constrained in types of products and the costs of those products that could be offered to consumers.

While centrally cleared exchanges strictly require cash collateral, individually negotiated OTC contracts allow hedging entities to use alternative collateral.... In some cases, because of the high creditworthiness of a hedging entity, there will be a reasonable threshold that must be reached before collateral would have to be posted. Providing such flexibility frees up scarce capital for investments in new energy infrastructure. Conversely, not allowing such collateral structures and forcing all OTC transactions to clear through exchanges would unnecessarily divert substantial capital from

productive investments and drive up the price of energy commodities.

In addition, for centrally cleared products to be effective, standardization and a critical mass of market participants to facilitate a robust market are key. [I]n the case of electricity, since its unique physical nature precludes significant storage and requires that it be consumed when generated, in hundreds of physical markets, the prerequisites for standardized and centralized clearing are missing....

Limiting access to risk management tools by mandating the clearing of OTC transactions would jeopardize the ability of energy providers to manage risks. [This would] increase consumer costs and consumer exposure to market volatility. The OTC markets' very purpose is to provide customized solutions that meet individual needs...with flexible products as well as diversified margin and collateral requirements....

[U]tilities purchase firm supplies in the physical delivery market at prevailing market prices and enter into OTC derivative agreements customized to meet their specific needs, reduce their consumers' exposure to future market price fluctuations, and stabilize rates. Similarly, electricity suppliers use OTC forward contracts to plan for and commit to future power needs when they do not own sufficient generation assets to meet [their] total electric demand.... [The] availability of OTC contracts allows [these suppliers] to avoid higher costs from the cash margin requirements of a clearinghouse or exchange and to secure true hedges of the prices of wholesale purchased power at hundreds of delivery points.

Protecting Consumers

Simply put, electricity and gas providers have a legitimate need to engage in bona fide risk management in OTC markets.... We stand ready to work with you to craft reforms that enhance transparency and improve overall market functions without creating unintended adverse consequences for us and the consumers we serve. ♦