IMPACTS OF H.R. 3795, "THE OVER-THE-COUNTER DERIVATIVES MARKET ACT OF 2009," ON ENERGY MARKETS

HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY AND ENVIRONMENT

OF THE

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HOUSE OF REPRESENTATIVES

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CONTENTS

WITNESSES

IMPACTS OF H.R. 3795, "THE OVER-THE-COUNTER DERIVATIVES MARKET ACT OF 2009," ON ENERGY MARKETS

WEDNESDAY, DECEMBER 2, 2009

SUBCOMMITTEE ON ENERGY AND ENVIRONMENT,
COMMITTEE ON ENERGY AND COMMERCE,
HOUSE OF REPRESENTATIVES,
Washington, DC.

The Subcommittee met, pursuant to call, at 1:22 p.m., in Room 2322 of the Rayburn House Office Building, Hon. Edward J. Markey [Chairman of the Subcommittee] presiding.

Members present: Representatives Markey, Doyle, Inslee, Butterfield, Matsui, McNerney, Welch, Dingell, Waxman (ex officio), Stupak, Upton, Stearns, Shimkus, Walden, and Scalise.

Staff present: Bruce Wolpe, Senior Advisor; Greg Dotson, Chief Counsel, Energy and Environment; John Jimison, Senior Counsel; Jeff Baran, Counsel; Joel Beauvais, Counsel; Melissa Cheatham, Professional Staff Member; Caitlin Haberman, Special Assistant; Lindsay Vidal, Special Assistant; Mitchell Smiley, Special Assistant; Andrea Spring, Minority Professional Staff Member; Aaron Cutler, Minority Counsel; and Sam Costello, Minority Legislative Analyst.

OPENING STATEMENT OF HON. EDWARD J. MARKEY, A REPRESENTATIVE IN CONGRESS FROM THE COMMONWEALTH OF MASSACHUSETTS

Mr. MARKEY. Welcome to the Subcommittee on Energy and Environment and this very important hearing.

As early as next week, the House will vote on legislation to strengthen the oversight of financial derivatives markets. This legislation provides the Commodities Futures Trading Commission a broad new authority to regulate over-the-counter trading in derivatives. This reform is long overdue.

Over the past 2 years, we have once again learned the hard way that deregulation of financial markets is a recipe for robbery and ultimately recession. I have long supported tough regulation of derivatives beginning in the late 1980s when I chaired what was then the Subcommittee on Telecommunications and Finance. In the early 1990s, I chaired the first Congressional hearings on the potential for over-the-counter derivatives to create systemic risk in global financial markets, and I warned of the risks that unregulated derivative dealer like AIG and Bear Stearns could pose for those markets.

I have also worked to strengthen competition and oversight in electricity markets. I was the author of the transmission access provisions of the Energy Policy Act of 1992, which promoted competition by requiring transmission owners to provide independent power providers with access to the grid. In the Energy Policy Act of 2005, I was amongst the principal supporters of the provision that gave the Federal Energy Regulatory Commission authority to protect against fraud and manipulation in electricity and natural gas markets.

So today's hearing isn't about whether or not we need strong oversight of energy markets; clearly, we do. It is about getting regulation right. We must ensure that financial regulatory reform doesn't disrupt FERC's ability to properly structure and oversee organized energy markets. Otherwise, we will undermine FERC's ability to ensure reliable and affordable service for American consumers. We must not let this effort to solve one crisis, create yet another.

The derivatives bill reported by the Agriculture Committee threatens to do just that. The bill's definition of swap is so broad that it is likely to cover a number of FERC-related products, including but not limited to Financial Transmission Rights that play a key role in the functioning of the organized electricity markets. These products are inextricably linked to the physical operation of the grid and they exist only because FERC has approved their terms and conditions. Congress has given FERC strong authority to protect against manipulation of these markets and there is broad agreement that FERC has exercised that authority thoroughly and competently. Nevertheless, under the pending derivatives bill, anything that falls within the definition of a swap is under the exclusive jurisdiction of the CFTC, and CFTC has no authority to exempt any swap from the full set of regulations that apply to financial markets.

What is the upshot of all of this? Well, FERC could be excluded from regulating the very markets it has created to ensure a reliable and affordable supply of electricity. In FERC's place would be substituted the CFTC, an agency with no expertise in this area. Such an outcome is unacceptable.

Chairman Waxman and I have proposed a straightforward and reasonable solution. First, the derivatives legislation should fully preserve FERC's existing statutory authority. Second, whether FERC and CFTC have overlapping authority, the two agencies should conclude a Memorandum of Understanding that sets the boundaries of their respective authority so as to ensure effective regulation. And third, in any area where the two agencies agree that FERC should have primacy, CFTC should be allowed to decline to exercise its regulatory authority.

We will be working in the coming days to ensure that a resolution along these lines can be reached before the derivatives bill is brought to the House floor. We expect that the members of the subcommittee and the full committee will play an active role in this discussion. This afternoon's hearing will help us to flesh-out the issues and potential solutions.

I thank the witnesses for their participation, especially the two chairmen who are sitting in front of us. They are working hard in trying to find a way of resolving these issues. We appreciate their efforts.

Let me now turn and recognize the ranking member of the subcommittee, the gentleman from Michigan, Mr. Upton.

Mr. UPTON. Thank you, Mr. Chairman, and just because the hearing started late, I want to defer my opening statement and I will defer to Mr. Shimkus.

Mr. MARKEY. The gentleman is recognized for that purpose.

Mr. SHIMKUS. Thank you and I want to thank my friend, Fred Upton. I have got to go over to the Capitol floor meeting on the Illinois Gitmo so that is where I am headed from here.

Thousands of companies use derivatives to manage risk. There are winners and losers in the market. One aspect of this bill is transparency and our focus on does this bill achieve this at the cost of the marketplace. With this bill that the Ways and Means and Ag have both passed, are we making it more difficult for these companies to manage risk? I have talked with many and this will cost them more and prices will go up. Will the CFTC and FERC both have jurisdiction? Will it be shared? One has in some instances, one in others. Does this bill make this clear or is this burdensome with the CFTC and the FERC or companies dealing in derivatives? Are any of these completely capable of this request and can they afford new cost placed upon them?

This is an important hearing, Mr. Chairman. We need to fix the agencies. We don't need to create new ones and we will be focusing on that.

I yield back my time. I thank Fred for the yielding.

Mr. MARKEY. The gentleman's time has expired.

The chair recognizes the Chairman of the full committee, the gentleman from California, Mr. Waxman.

OPENING STATEMENT OF HON. HENRY A. WAXMAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. WAXMAN. Thank you very much, Mr. Chairman.

Today we are examining whether the derivatives reform legislation reported out of the House Agriculture Committee could disrupt the Federal Energy Regulatory Commission's current regulation of critical regional electricity markets. The pending legislation is intended to bring greater transparency and accountability to derivative markets. I absolutely support that goal however the bill's broad definition of swaps is so inclusive that it threatens to displace comprehensive FERC regulation over regional electricity market products. The bill could be read to assign exclusive and mandatory authority over those products to the Commodities Futures Trading Commission.

In 2000 and 2001, California experienced a severe energy crisis. There were blackouts. There was economic chaos. Energy prices in the State skyrocketed. We were being victimized by unscrupulous traders in both power and transmission rights. FERC, at the time, was soundly asleep and unresponsive to the alarms we raised. But in the wake of that California energy crisis, Congress amended and Mr. Markey indicated he was the author, changes in the Federal Power Act to give FERC authority to prevent and punish fraud in market manipulation. We thought FERC had that authority but during that period of time, they claimed they needed clearer statutory authority. Well, if the legislation reported out of the Agriculture Committee is not adjusted to preserve the authority of FERC, it could undermine authorities that Congress gave FERC in the aftermath of that energy crisis to investigate and penalize market manipulation.

FERC has strengthened its monitoring and enforcement practices. No one, including the CFTC or sponsors of H.R. 3795, has suggested to us that the current regulatory regime to prevent market manipulation or abuse in FERC's organized regional markets is broken, so we need to ensure that efforts to strengthen derivative regulation don't weaken existing regulation. Before H.R. 3795 is considered on the House floor, members need to understand how it would affect the organized regional markets FERC has created and comprehensively regulated pursuant to detailed tariffs. These markets not only exist because FERC created them, the products traded in these markets are directly linked to the physical limits of the transmission system and are not traded on broad exchanges. We need to make sure that the legislation doesn't unintentionally displace FERC as the regulator of the markets FERC has created.

This hearing is an important opportunity for us to find out what impact the proposed legislation may have on these critical markets and what changes to the legislation may be appropriate. I appreciate the expert witnesses here to help us understand its implications. Our committee has a tradition of acting only on the basis of a thorough understanding of the issues before it and I believe we can help to improve H.R. 3795 before it is voted upon. And I believe we are going to need changes in that legislation that is reported out of the Agriculture Committee to make sure that we don't have consequences that would be harmful to what the good job that FERC is doing in this regard and should continue to be able to do.

Thank you, Mr. Chairman.

Mr. MARKEY. Gentleman's time has expired.

The chair once again recognizes the ranking member, Mr. Upton.

OPENING STATEMENT OF HON. FRED UPTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. UPTON. Thank you, Mr. Chairman, and I do appreciate having this important hearing today.

We have two very distinguished panels and we are fortunate to be able to hear their thoughts and concerns for the legislation. H.R. 3795 as reported out of the Ag Committee has some serious flaws that would negatively impact the energy sector and I, like many members of this subcommittee, oppose the legislation in its current form, and it is my understanding that both Mr. Waxman, Mr. Markey, Mr. Barton do share my concerns and I hope that we can work together to change the bill before it is brought to the House floor as early as next week.

As written, H.R. 3795 could lead to an increased energy cost for all Americans and disrupt our nation's energy markets. By limiting access to certain risk management tools as this legislation does, the ability of energy providers to hedge their market risks would be jeopardized and their customers would be vulnerable to increased price volatility. I understand that there is an appetite among many of my colleagues to create new regulations to curb systemic risk in the economy as a whole but this legislation engulfs markets that are working properly, and in doing so creates new problems that our economy and energy consumers do not need during these very difficult times.

The legislation will undermine authorities that Congress gave FERC to investigate and penalize market manipulation. As part of the Energy Policy Act of '05, FERC was given the authority to protect electric and natural gas markets against manipulation or fraud by ensuring the transparency of those markets. FERC's ability to exercise these authorities to the full extent Congress intended would be in question with the passage of this bill.

Additionally, under current law, FERC regulates interstate transmission and sale of electricity to ensure that electricity prices are just and reasonable. However, this legislation would disrupt transmissions markets by creating what would amount to contradictory regulation by the CFTC. So this bill, H.R. 3795 in current form I don't believe is ready for primetime and I would hope that in the tough times of double-digit unemployment and a sagging economy as we try to get our businesses back to work and employing folks that this legislation will not move as it is. Let us work together to get it right.

I look forward to the testimony and questions and I yield back.

Mr. MARKEY. Gentleman's time has expired.

The chair now recognizes the gentleman from Michigan, Mr. Dingell. I recall vividly the gentleman from Michigan back in 2005, and the energy conference fighting vigorously in that conference committee to ensure that the anti-fraud, anti-manipulation language was included in that legislation and to a very large extent, that is at the core now of what we are debating. So since I have a vivid memory of that battle and it was the gentleman from Michigan who was leading the fight, I yield him the time for an opening statement.

OPENING STATEMENT OF HON. JOHN D. DINGELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. DINGELL. Thank you, Mr. Chairman, and I very much appreciate your kind remarks. I will commend you for holding this hearing which I view as very important. If H.R. 3795, the Over-The-Counter Derivatives Act of 2009 is acted upon without significant input from the Committee on Energy and Commerce, much of the work that has been done by this committee over the years going back to before I was in this body to back when Sam Rayburn was Speaker, will be undone, and FERC will probably lose significant authority to protect electric and natural gas markets against fraud and manipulation, and worse then that, consumers will be denied protection of a consumer protection agency in favor of an agency that has a long tradition of failure in protecting consumers. So thank you for doing this hearing today, Mr. Chairman.

Most recently in the Energy Policy Act of 2005, as you mentioned, the Congress acting on the suggestions of this committee gave broad authorities to FERC to protect against fraud and market manipulation to ensure price transparency in the electricity and natural gas markets. That has worked well and I look forward to hearing from Chairman Wellinghoff of FERC on the various oversight mechanisms that FERC has in place to ensure proper functioning of various markets. Collaterally, we will look forward to hearing our other witness tell us why it is that he can do better.

If H.R. 3795 were enacted into law without further amendment, there is a serious potential that many of the instruments used and organized in regional electric markets and currently regulated by FERC would either be displaced by the Commodities Futures Trading Commission or confusing overlaps and conflicts would be created. In the past, such conflicts have led to FTC and a hedge fund jointly litigating to strip FERC of its consumer protection authorities. This would not seem to be beneficial then to consumers and it has been a matter of bipartisan concern as today's record will show. In fact, one of our witnesses today will testify that consumers would see a rate increase of 5 to 15 percent if these activities are forced into exchanges.

Following the energy bubble price in natural gas and electricity markets during 2008, FERC economists found that this was caused in significant part by excessive speculation in futures and derivatives markets for natural gas. We will want to hear from the chairman of CFTC what they did about those matters at that time. Likewise, it was FERC that discovered a sharp spike in speculative activity in natural gas futures that led to the prosecution of the hedge fund, Amaranth Advisors. FERC's admission is simple, assist consumers in obtaining reliable and efficient energy services at a reasonable cost through appropriate regulatory and market mechanisms. However, when one considers the complexity of such task, it is critically important that the agency with years of experience and understanding of energy markets and a fine staff expertise required to carry out such a task, should be allowed to continue its successful work. We will also want to inquire as to why we have need of new intrusion into these matters by an agency without any prior expertise in these matters.

I thank you, Mr. Chairman.

Mr. MARKEY. The gentleman's time has expired.

The chair recognizes the gentleman from Florida, Mr. Stearns.

OPENING STATEMENT OF HON. CLIFF STEARNS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. STEARNS. Thank you very much, Mr. Chairman.

I think the consensus on both sides is that FERC has done a good job of closely regulating and monitoring the regional transmission organizations and independent systems operator through the use of tariffs and audits and investigations and they should, I think the consensus is at least both parties here that they should remain the sole regulatory authority over such markets. However, obviously this bill acts in such a way to establish a new and I believe overly expansive definition of swap that would give the Commodity Futures Trading Commission this exclusive authority over a number of transactions that are already extensively regulated by FERC.

Now, the regulation by FERC for 15 years here has been successful and, my colleagues, the products that they regulate did not contribute to the meltdown so it is not clear to me why we are moving forward on this. We all agree that transparency is important. Accountability and stability in the nation's financial market is important to minimize systematic risk and prevent another financial crisis but the organized power in the markets and the FERC regulatory system did not cause this meltdown. Any over-the-counter derivative legislation should address problems associated with unregulated financial derivatives and not inadvertently include FERC regulated markets that do not involve this type pf risk that this legislation is proposing. Continued unhindered operation of our energy markets are vital obviously to meeting our electricity needs of millions of Americans and obviously many of us don't see there is a need for a major shift in the oversight of these markets.

So I think, Mr. Chairman, you and Mr. Waxman and Mr. Upton have all voiced this clearly and I think that it is very good that we have a hearing and confirm that we all believe.

Mr. MARKEY. We thank the gentleman very much.

The chair recognizes the gentleman from Pennsylvania, Mr. Doyle.

OPENING STATEMENT OF HON. MICHAEL F. DOYLE, A REPRESENTATIVE IN CONGRESS FROM THE COMMONWEALTH OF PENNSYLVANIA

Mr. DOYLE. Mr. Chairman, thank you for holding this hearing and inviting all of the important stakeholders to provide their testimony today.

In particular, I am happy to see Vincent Duane from PJM here today. As you know, PJM is the regional transmission organization that keeps the lights on in my district and I think it is important to get their input on how this bill will affect them.

I am glad we are holding this hearing today to bring attention to some potential unintended consequences of reforming our financial regulatory system. It was only a year ago that our financial system was on the edge of grinding to a halt. Though there were many contributing factors, lack of regulations in our commodities market undoubtedly added to the problem.

I applaud my colleagues, the chairman of the House Financial Services and Agriculture Committee, for their work on this legislation to remedy the poor regulation of over-the-counter derivatives and force irresponsible speculators out of the market. However, in their attempt to be thorough, I am concerned that my colleagues have overlooked a duplicative effect that this bill could have on energy markets at the end of the day, rate payers, also.

Since the creation of regional transmission organizations, FERC has had a responsibility to monitor energy markets in each RTO and review and report on any hint of manipulation or abuse. In fact, with the passage of EPACT 2005, we gave FERC even greater authority to protect against fraud and abuse in electricity and natural gas markets. Let me be clear, we need to clean up our financial derivatives markets and I think this bill does a good job of getting us there. The CFTC needs to increase oversight and control of these financial products and bring more transparency to the swaps market. We just need to be sure that it doesn't inadvertently require our RTOs to endure another layer of regulation that would keep them from providing electricity to consumers at competitive rates.

I look forward to the testimony from all our distinguished witnesses and hope that we can produce an excellent bill to bring to the floor. With that, Mr. Chairman, I will yield back my time.

Mr. MARKEY. Gentleman's time has expired.

The chair recognizes the gentleman from Louisiana.

OPENING STATEMENT OF HON. STEVE SCALISE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. SCALISE. Thank you, Mr. Chairman.

I am strongly in favor of pursuing policies that prevent another financial market collapse from occurring and I strongly support increasing transparency and oversight in our financial markets. However, I have serious concerns about provisions in this bill that will raise utility costs on every American family and will ship thousands more American jobs overseas. Derivatives serve many purposes including stabilizing prices and ensuring future deliveries of commodities. Market participants also use derivatives to ensure that consumers are protected from sudden price hikes and other events including natural disaster that can negatively impact costs. While I support increasing oversight and transparency to reign in the large financial institutions which contributed to the current economic crisis, we need to make sure to consider the effects on those who play by the rules.

Mr. Chairman, as with cap and trade and other reckless policies, these proposals would kill American jobs and increase costs for businesses and families across this country. From the perspective of my position on this committee, I have serious concerns about the utility rate hikes that will result from provisions in this bill but it doesn't stop there. We are seeing a dangerous trend with this administration and the Democrats running Congress. Provisions in this bill will have serious negative impacts on our economy and these proposals taken with the cap and trade energy tax and the government takeover of healthcare will prohibit our small businesses, those very job creators in our country from getting our economy back on track. These reckless policies will result in billions of dollars in new taxes on American families, millions of American jobs lost and shipped overseas and the destruction of our economy. In this current economic crisis, our focus should be on creating new jobs not more reckless policy that run jobs out of our country.

Again, Mr. Chairman, I am strongly in favor of pursuing policies to prevent bad players from bringing down our markets in the future and I believe that oversight and transparency are key components to that goal. The American people are asking where are the jobs and all they get from this tone-deaf Congress are more radical schemes that raise taxes on American families and run more jobs out of our country. Enough is enough.

Thank you and I yield back.

Mr. MARKEY. Gentleman's time has expired.

The gentlelady from California, Ms. Matsui.

OPENING STATEMENT OF HON. DORIS O. MATSUI, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Ms. MATSUI. Thank you, Mr. Chairman. Thank you for calling today's hearing.

I would like to thank today's panelists for joining us today to discuss legislation that would affect FERC's jurisdictional markets and the transactions and products created for use in these regulated markets. I look forward to hearing all of your expert opinions. The expertise you share here will be useful throughout the committee process as we continue to discuss these matters.

I think all of us here would agree that the recent financial crisis revealed serious weaknesses in the U.S. financials regulation. While it is critical that we respond to the risky trading strategies that nearly brought the American economy to the brink of collapse, it is equally crucial that we acknowledge the potential effects that legislative efforts to improve transparency and stability in over-the-counter derivatives markets may have on our energy markets, particularly electricity and natural gas. Toward this end, I believe that it is important to note that electric utilities and other stakeholders have expressed serious concerns about providing the CFTC the authority already possessed by FERC to regulate regional electric markets.

In my district, the Sacramento Municipal Utility District, SMUD, enters into natural gas supply contracts and OTC derivative agreements to reduce Sacramento's exposure to price volatility. Unfortunately, most Californians vividly recall at the beginning of this decade the rationing of electricity which led to an artificial scarcity that created opportunities for market manipulation by energy speculators. We cannot allow our best intentions to examine regulatory authorities to impair the ability of utilities to employ tools to manage price risk and help keep rates affordable for consumers, and we need to continually examine systemic risk and the implications of applying certain means of transparency to the derivatives markets.

I look forward to hearing from the panelists on the bill before us today, and working with the committee and stakeholders on these important matters. Once again, I thank you, Mr. Chairman, for highlighting this important topic and I yield back the balance of my time.

Mr. MARKEY. Thank the gentlelady.

The chair recognizes the gentleman from North Carolina, Mr. Butterfield.

OPENING STATEMENT OF HON. G.K. BUTTERFIELD, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

Mr. BUTTERFIELD. Thank you very much, Mr. Chairman, for convening this important hearing.

I am not an expert on these matters and I have tried to learn as much as I can but from what I can understand, these products minimize risk in a capricious system for end users. Unfortunately, excessive over-the-counter trading by speculators continues to increase the risk for system irregularity and unpredictability. I am pleased given the number of important domestic priorities vying for our attention that Congress is paying close attention to reforming the way we regulate derivatives. We simply cannot afford the risk of allowing the system to operate like an open casino and I appreciate the work thus far done on this bill by the two committees. Still, as the chairman stated it is critical that this subcommittee question the imprecise definitions in the bill given the potential problems such ambiguity would create for end users.

Last year, the newspaper in my district reported on the importance of derivative for one of North Carolina's largest utilities, Progress Energy. Manned, round-the-clock progress power traders make OTC trades to hedge against risk and find the lowest energy prices that are available. These activities are critically important to minimize risk. According to our State utility commission officials interviewed in the article, electricity rates would be at least double, that is double, without the success of Progress' trading department. I mention this to illustrate just how critical these financial instruments are in controlling costs for consumers. I welcome and encourage the transparency this legislation would create and I am hopeful that the legislation will be crafted in a way that ensures that end users can continue to enjoy these cost-cutting benefits.

I look forward and thank the witnesses for their testimony today and this microphone is not working.

Mr. MARKEY. Gentleman's time has expired.

The chair recognizes the gentleman from Vermont, Mr. Welch.

Mr. WELCH. I will waive my opening statement.

Mr. MARKEY. The chair recognizes the gentleman from Washington State, Mr. Inslee.

I am sorry. I had an obstructed view here. The chair recognizes the gentleman from California, Mr. McNerney.

Mr. MCNERNEY. Thank you, Mr. Chairman, for convening today's important hearing on the potential impacts of H.R. 3795 on energy markets. Reforms to our financial regulatory system will affect the energy sector and consumers and I appreciate the opportunity to hear the perspective provided by our witnesses today.

As Congress proceeds with financial regulatory reform, it is important that we avoid creating unnecessary bureaucratic or jurisdictional impediments. We should build on the regulatory processes that are functioning well, while at the same time fixing flaws in the system. I am committed to working with my colleagues, with outside experts, with energy stakeholders to ensure that reforms increase transparency, protect consumers and allow businesses to grow and hire new workers. We should also carefully examine the potential consequences that legislative proposals pose for derivatives end users who represent a broad spectrum of businesses across America.

And with that, I will yield back the balance of my time.

Mr. MARKEY. Gentleman's time has expired.

The chair recognizes the gentleman from Washington State, Mr. Inslee.

Mr. INSLEE. I will waive. Thank you, Mr. Chair.

Mr. MARKEY. And all members of the subcommittee have completed their opening statements and by unanimous consent we will recognize the gentleman from Michigan, Mr. Stupak, to make an opening statement.

Mr. STUPAK. Mr. Chairman, thank you for your courtesy but I will waive this opening statement.

Mr. MARKEY. Great, well, we thank the gentleman for that.

So we will turn to our very distinguished panel and recognize our first witness, Chairman Jon Wellinghoff of the Federal Energy Regulatory Commission. As the head of FERC, Chairman Wellinghoff oversees wholesale electricity transactions and interstate electric transmission in the United States amongst other matters. He has been a member of the Commission since 2006, and was appointed chairman by President Obama in March of this year. Thank you for joining us this afternoon, sir. Whenever you feel comfortable, please begin.

STATEMENTS OF JON WELLINGHOFF, CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION; AND HON. GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

STATEMENT OF JON WELLINGHOFF

Mr. WELLINGHOFF. Good afternoon, Chairman Markey.

Mr. MARKEY. If you could move that microphone down a little bit closer to you.

Mr. WELLINGHOFF. Will do that. I think it is on.

Chairman Markey, Chairman Waxman, Ranking Member Upton and members of the subcommittee, I would ask that my full testimony be submitted for the record.

Mr. MARKEY. Without objection, it will be included.

Mr. WELLINGHOFF. Thank you and I will summarize as follows.

Organized wholesale electric markets are currently operated by independent entities called Regional Transmission Organizations or Independent System Operators. They are legally considered to be public utilities and fully under the jurisdiction of the Federal Energy Regulatory Commission. FERC fully and comprehensively regulates these wholesale electric markets and all products traded in those markets. That regulation extends both to the organization of those markets through thousands of pages of market tariffs and rules specifically and exclusively approved by FERC, and to their operation through FERC's extensive oversight, monitoring and enforcement. The products in those markets are intentionally linked in a structure established by FERC in an integrated market design that is intended to ensure that rates and services in those markets are just and reasonable. In addition to ensuring that market participants do not engage in market manipulation and fraud, only FERC has a Congressional mandate to ensure that rates charged and the services provided in these markets are just and reasonable.

Duplicative oversight and enforcement in the RTO electric markets by the CFTC would create market uncertainty and the potential for disruption of market structure such that rates and services could no longer be found by FERC to be just and reasonable. Further, such duplication would result in market inefficiencies and higher costs for consumers through higher cost of capital and additional regulatory expense. Interposing a new regulator unfamiliar with the purpose and dynamic structure of these markets would not serve the public interest.

Last month, Chairman Gensler testified that giving the Federal Reserve certain authority in financial markets as "a potential of setting up multiple regulators overseeing markets and market functions of the United States." He also stated that "While it is important to enhance the oversight of markets by both the SEC and the CFTC, I think Congress would want to closely consider whether it is best to set up multiple regulators for some functions."

The context of today's hearing is different but the concern is the same. Any improvements warranted in the RTO and ISO markets can be made by FERC. Interposing a new regulator or having multiple regulators has not been justified, is not needed and would be harmful to the consumers that we are all charged to protect.

That completes my summary. I would be happy to answer any questions of the subcommittee. Thank you.

[The prepared statement of Mr. Wellinghoff follows:]

Testimony of Chairman Jon Wellinghoff
Federal Energy Regulatory Commission
Before the Energy and Environment Subcommittee
Of the Committee on Energy and Commerce
United States House of Representatives
Impacts of H.R. 3795,
the Over-the-Counter Derivatives Markets Act of 2009,
on Energy Markets
December 2, 2009

Mr. Chairman, Ranking Member Upton and members of the Subcommittee:

Thank you for the opportunity to appear before you today. My testimony will address the creation, operation and oversight of electric markets conducted by regional transmission organizations (RTOs) and independent system operators (ISOs), and how they may be affected by current or future laws focused on financial derivatives. Whatever decisions Congress makes for currently-unregulated financial derivatives, those decisions should not apply to RTO/ISO markets, which are already regulated fully, comprehensively and effectively by FERC. Any amendments to the Commodity Exchange Act should preserve FERC's exclusive oversight of RTO/ISO rates, terms and conditions for power sales and transmission service, and prevent dual regulation of RTO/ISO markets by FERC and the Commodity Futures Trading Commission (CFTC).

As my colleague, Chairman Gensler, recently testified to the House Committee on Agriculture about certain financial markets: "While seeking to address the gaps and inconsistencies that exist in the current regulatory structure of complex, consolidated financial firms, the proposals also may have unintentionally encompassed robustly regulated markets...." The RTO/ISO markets are just such robustly regulated markets, developed and refined under FERC's supervision over the last ten years. They are, as Representative Frank Lucas at the same hearing reportedly described, "specialized, nuanced market[s]," with "competent regulators and an effective regulatory scheme."

Background

Since the late-1970s, Congress has encouraged competition in the electric industry. This effort has included legislation such as the Public Utility Regulatory Policies Act of 1978 (facilitating market entry by combined heat-and-power facilities and small renewable energy facilities), the Energy Policy Act of 1992 (expanding FERC's authority to require transmission service upon customer application, and reducing barriers to entry by independent power producers) and the Energy Policy Act of 2005 (reducing barriers to investment in the industry, subject to protection against cross-subsidization by ratepayers).

The Commission also has encouraged competition. FERC's Order No. 888, issued in 1996, was a landmark in this effort, requiring public utilities to offer transmission service to others on non-discriminatory rates, terms and conditions. Order

No. 888 also encouraged the formation of ISOs, to operate all of the transmission facilities in a geographic area. ISOs were aimed at encouraging competition by facilitating development of regional power markets, and enhancing trading opportunities for a region's buyers and sellers. Several years later, FERC's Order No. 2000 encouraged the formation of RTOs, which perform the same transmission functions as ISOs but generally are larger in geographic scope. Today, RTOs and ISOs operate not only transmission facilities but also markets for trading electric energy among utilities.

RTO and ISO power markets and transmission services are tightly integrated, and regulated to an extent beyond most other markets. The rules for RTO and ISO markets are specified in lengthy tariffs (hundreds or thousands of pages) reviewed and approved by FERC. In order to analyze these tariffs, the Commission draws upon expertise in various disciplines, including attorneys, economists, energy industry analysts, and engineers. The tariffs contain numerous requirements and mechanisms to ensure reasonable rates and a reliable supply of electricity. These rules are carefully designed to facilitate competitive forces within a heavily-regulated industry. The RTOs and ISOs themselves are not "self-regulating organizations," but are legally considered to be "public utilities" and in fact are regulated more extensively than other public utilities.

Generally, the Commission's responsibility in the energy industries is to ensure that consumers have adequate supplies of energy at reasonable prices. More specifically, Federal Power Act sections 205 and 206 require the Commission to ensure that the rates, terms and conditions offered by RTOs, ISOs and other public utilities are just, reasonable and not unduly discriminatory. This responsibility applies to wholesale sales and transmission of electricity in interstate commerce, as well as contracts or other arrangements and practices significantly affecting those sales and services.

Commission staff monitors the RTO and ISO markets to ensure that the markets are functioning efficiently and appropriately. This is done by monitoring market results and conditions (e.g., RTO and utility load forecasts, weather and outages) and identifying anomalies. When the available data does not explain the anomalies, staff examines the matter and, if legitimate reasons are not found, investigations are initiated to determine if fraud or manipulation has occurred.

The Commission also requires each RTO or ISO to have an independent market monitor. The market monitors can review all market activities in real-time. They also evaluate market rules and recommend changes, review and report on the performance of these markets, and must refer to the Commission any potential violations of the Commission's rules, regulations or orders.

The Energy Policy Act of 2005 gave the Commission the authority to assess substantial penalties (a million dollars a day per violation) for fraud and market manipulation, including manipulation of RTO and ISO markets. The Commission has initiated several proceedings based on this authority. This authority applies to participants in RTO and ISO markets as well as any other entity engaging in fraud or market manipulation in connection with a FERC-jurisdictional transaction.

FERC's efforts on market oversight and enforcement have increased greatly in recent years. At the start of this decade, FERC investigatory staff consisted of 14 attorneys and a few support personnel within its Office of General Counsel. Today, staff in FERC's Office of Enforcement (including market oversight, investigations, audits and financial regulation) numbers over 180, including 40 attorneys in its Division of Investigations. For fiscal year 2009, FERC's efforts yielded settlements worth approximately $38 million in penalties and $38 million in disgorgement. Six of those matters involved market manipulation claims and accounted for approximately $20.8 million in penalties and $28.8 million in disgorgement.

Financial Transmission Rights

The question of CFTC regulation of RTOs and ISOs has arisen in several contexts. Examples include RTO/ISO markets for financial transmission rights (FTRs), capacity markets and day-ahead markets. Another example is the question of whether RTOs/ISOs should be considered "clearing" organizations within CFTC jurisdiction. I will focus on FTRs, as an illustration of the possible effects of CFTC regulation in these areas.

FTRs allow customers to protect against the risk of price increases for transmission services in RTOs/ISOs. An FTR is a right to avoid, or be compensated to the extent of, congestion costs between two specific points. For example, if the transmission capacity going from Point A to Point B is 500 MW, but transmission customers seek to send 600 MW of power from Point A to Point B, the path will be congested, and the price of service will increase. The increase is referred to as congestion costs.

In general, load-serving entities in RTOs/ISOs are allocated either FTRs or rights convertible into FTRs. The allocation is generally based on usage during a historical period, as modified in certain circumstances for later changes. While allocated FTRs are generally limited to load-serving entities and to those who funded construction of specific transmission facilities, other FTRs are auctioned and these generally can be purchased by any creditworthy entity.

Historically, FTRs were developed to give load-serving entities price certainty similar to the pricing methods in non-RTO/ISO markets. In most cases, FTRs have terms of one year or less. In the Energy Policy Act of 2005, however, Congress enacted Federal Power Act section 217, requiring FERC to use its authority in a way that enables load-serving entities to secure FTRs on a long-term basis for long-term power supply arrangements made to meet their customer needs.

Unlike "futures contracts," FTRs are available only to the extent allowed by the physical limits of the grid. All of the FTRs must be "simultaneously feasible" on the grid. Markets for FTRs include hundreds or thousands of different FTRs (for each pairing of receipt and delivery points) and thus are much more fragmented and less liquid than typical contracts traded on futures exchanges.

FTR markets do not pose systemic risk to the economy. All FTR markets combined amount to roughly several billion dollars. This market level fluctuates depending on the level of physical congestion in each RTO and is expected to decrease substantially as more transmission is built relieving congestion.

The Commodity Exchange Act and H.R. 3795

Questions have been raised about whether RTOs and ISOs, including FTRs or other RTO/ISO products, fall within CFTC jurisdiction under the Commodity Exchange Act. Similar questions arise under H.R. 3795.

For example, some may argue that an FTR is a solely financial arrangement and constitutes a futures contract under the Commodity Exchange Act, or that an RTO or ISO is a "derivatives clearing organization" under that Act. Either of these arguments, if accepted, may establish CFTC jurisdiction.

Moreover, my understanding is that the CFTC construes its jurisdiction under the Commodity Exchange Act to be exclusive. If so, the issue could become, not whether to allow dual regulation by FERC and the CFTC, but whether FERC regulation will be ended and replaced by CFTC regulation.

Under H.R. 3795, some may argue that FTRs fit within the definition of a "swap," or that RTOs/ISOs fit within the definitions of a "swap dealer" or "major swap participant." If so, these markets or entities may be subjected to a regulatory scheme crafted for circumstances entirely unrelated to, and arguably ill-suited for, the organized power markets.

Application of H.R. 3795 to RTOs and ISOs may raise an additional problem. The Commodity Exchange Act currently allows the CFTC in certain circumstances to grant exemptions from its requirements. Even if the CFTC interprets the Commodity Exchange Act as applying to RTOs and ISOs, the CFTC may have discretion under the current provisions of that Act to exempt RTOs and ISOs from some or all of its requirements. H.R. 3795, however, would limit more narrowly the CFTC's authority to grant exemptions from its requirements, and may preclude the CFTC from taking such action. I am not arguing against this aspect of H.R. 3795, but merely noting its possible effect if H.R. 3795 is applied to RTOs and ISOs.

Congress Should Preserve FERC Regulation of RTOs/ISOs

In addition to offering FTRs, certain RTOs and ISOs operate day-ahead and real-time energy markets, capacity markets and ancillary service markets. The rules for determining the prices for various power sales and transmission services – including congestion costs – are inextricably intertwined in the tariffs and in software as an integrated market design.

All elements of these markets are approved by FERC, incorporated into FERC-approved tariffs, and monitored closely by the independent market monitors and FERC. Subjecting one or more of these to CFTC regulation could disrupt the integrated functioning of RTO/ISO markets, leading to market inefficiencies and higher energy costs for consumers.

For example, as noted above, load serving entities generally are allocated FTRs as a means to hedge the transmission costs they incur and, ultimately, recover from their customers. CFTC requirements on position limits could conceivably require different allocations than the tariff rules approved by FERC, even though CFTC-type position limits have not been needed in the past to ensure reasonable results. A utility currently allocated, e.g., half of the FTRs on a transmission path it has used and funded for many years could find its allocation reduced significantly, and find itself unhedged against congestion costs.

Similarly, subjecting FTRs to CFTC clearing rules could conflict with FERC-approved tariff provisions on creditworthiness. FERC-approved tariffs reflect a balance between limiting the risk of defaults and unduly increasing the costs incurred by market participants and, ultimately, consumers. FERC also recognizes that different approaches to credit may be warranted for different types of power market participants (such as municipal utilities, cooperative utilities and federal agencies), unlike the one-size-fits-all approach that may suit other markets. There is no reason to assume that policies crafted by the CFTC in a different regulatory context apply equally well here.

Congress has recognized FERC's role in ensuring that FTRs help protect utilities and their customers from increases in the cost of transmission service. As noted above, Congress in 2005 enacted Federal Power Act section 217, requiring FERC to use its authority in a way that enables load-serving entities to secure FTRs on a long-term basis for long-term power supply arrangements made to meet their customer needs.

Moreover, Congress has indicated that RTOs and ISOs should be regulated exclusively by FERC. When Congress enacted the Food, Conservation, and Energy Act of 2008 and gave the CFTC authority over "significant price discovery contracts [SPDCs]," the Conference Report stated (on page 986) that "[i]t is the Managers' intent that this provision [on SPDCs] not affect FERC authority over the activities of regional transmission organizations or independent system operators because such activities are not conducted in reliance on section 2(h)(3) [of the Commodity Exchange Act]." In a colloquy with Senator Bingaman, Senator Levin emphasized this point, stating that "it is certainly my intention, as one of the amendment's authors – that FERC's authority over RTOs would be unaffected." Cong. Rec., Dec. 13, 2007, S15447. More recently, the House of Representatives passed H.R. 2454, the American Clean Energy and Security Act of 2009, which (in section 351) would amend the Commodity Exchange Act to define "energy commodity" as including "electricity (excluding financial transmission rights which are subject to regulation and oversight by the Federal Energy Regulatory Commission.)"

Congress has taken care to avoid duplicative regulation elsewhere in the electric industry. For example, the Federal Power Act exempts state agencies from regulation as public utilities; preserves State authority over local distribution and intrastate commerce (including much of Texas); and exempts cooperatives from regulation as public utilities if they are financed by the Rural Utilities Service. The same approach of avoiding duplicative regulation is warranted for the organized power markets.

The impetus for H.R. 3795 is the recent financial turmoil caused by certain unregulated financial derivatives and other factors. As Chairman Gensler stated in recent testimony before the House Committee on Agriculture: "One year ago, the financial system failed the American public. The financial regulatory system failed the American public." He also stated that "[w]e now face a new set of challenges as the nation continues to recover from last year's failure of the financial system and the financial regulatory system." The organized power markets, and FERC's regulatory system, did not cause these problems. Any response by Congress should address the source of these problems, and not inadvertently sweep in the FERC-regulated markets, since these have continued to perform well.

In short, the RTO and ISO markets should remain subject to FERC's exclusive jurisdiction. FERC encouraged development of these markets, and has regulated all of their rules, for the purpose of facilitating pro-consumer competition. FERC has many years of experience with the development and functioning of these markets. While I and others continue to seek improvements in these markets, I see no problem in these markets that would be solved by supplementing or displacing FERC oversight with CFTC oversight. No regulatory failure has occurred that would warrant such a major shift in oversight of these markets. These markets are vital in meeting the electricity needs of many millions of Americans, and nothing has been proffered to warrant the uncertainty of inserting a new regulator and a new regulatory regime.

Conclusion

Last month, Chairman Gensler testified that giving the Federal Reserve certain authority in financial markets "has the potential of setting up multiple regulators overseeing markets and market functions in the United States." He also stated that "[w]hile it is important to enhance the oversight of markets by both the SEC and CFTC, I think Congress would want to closely consider whether it's best to set up multiple regulators for some functions." The context of today's hearing is different, but the concern is the same. Any improvements warranted in RTO and ISO markets can be made by FERC. Interposing a new regulator, or having multiple regulators, has not been justified, is not needed and would be harmful.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

Our next witness is Gary Gensler. He is the chairman of the Commodity Futures Trading Commission. Chairman Gensler previously served at the United States Department of Treasury as Undersecretary of Domestic Finance during the Clinton Administration and prior to joining Treasury he worked for 18 years at Goldman Sachs where he was a partner and co-head of finance. He was sworn in as chairman of the Federal, of the CFTC in May by President Obama. We welcome you back to the committee actually, Mr. Chairman. Whenever you feel comfortable, please begin.

STATEMENT OF GARY GENSLER

Mr. GENSLER. Mr. Chairman, again if my full statement could be in the record, I will just try to summarize.

Mr. MARKEY. Without objection, it will be included at the appropriate place.

Mr. GENSLER. Chairman Markey, Ranking Member Upton, Chairman Waxman, it is good to be back here. I believe about 10 years ago I was in front of this committee or the full committee, and I thank you for inviting me to testify regarding regulation of the over-the-counter derivatives markets, particularly with respect to energy markets.

If I might just before I turn to that discuss a little bit what the CFTC is and we do as an agency. We oversee, as you know, risk management contracts called futures. We regulate these markets to ensure market integrity, protect against fraud and manipulation, promote transparency of the price discovery function to help lower risk to the American public. We have broad surveillance and enforcement powers and regulate, of course, exchanges, clearinghouses and then the intermediaries that bring transactions there. The CFTC's exclusive jurisdictions over the futures markets coexist alongside other agencies' jurisdiction for underlying commodities. For instance, Department of Agriculture regulates marketing standards for corn and cash milk prices and the CFTC regulates corn and milk futures. The Treasury Department oversees the issuance of all Treasury Bills, Notes and Bonds while, of course, the CFTC oversees Treasury futures. And the Federal Energy Regulatory Commission oversees many elements of the energy markets that this committee is familiar with including natural gas pipelines and electricity markets while the CFTC oversees natural gas and electricity futures. So we live and coexist along other Federal regulators.

The CFTC currently oversees futures trading in crude oil, natural gas, electricity and other energy products, gasoline and ore and so forth. Just to give an example, so far this year futures equivalent to 114 billion barrels of oil have traded with the notional amount of nearly $7 trillion this year on the futures exchanges that we oversee. Natural gas, a similar number would be nearly $1.6 trillion of notional amount of natural gas futures. Electricity actually has futures on the NYMEX, on ICE and on a small exchange you might not have heard of, the Nodal Exchange, outside of this RTO issue that again we oversee some of these futures markets and there, there is about 23 million contracts have traded.

It is about 7 percent of the overall energy futures market is actually in electricity markets.

Now, the over-the-counter derivatives market is that which is currently not regulated by FERC, by the CFTC, by any other Federal regulator and we believe that that is certainly part of the crisis last year, not the only part of the crisis but that we need broad reform in the over-the-counter derivatives market and it is currently out of sight of Federal regulators. As Congress considers this, I believe there are two principal goals, to lower risk to the American public and promote transparency to the American public, and statutory exemptions can undermine those two principal goals as we move forward and as we have seen sometimes in the past can lead to unintended consequences.

In terms of transparency, four quick things, one, the administration has proposed that all standardized derivative transactions be moved to under regulated transparent exchanges. This allows for every treasurer, every assistant treasurer of a corporation to see where the real time trading is happening in standard contracts. Customized transactions should still be allowed but the dealers would be subject to comprehensive regulation. Two, all non-cleared transactions, those too customized to be on those exchanges should be in a trade repository and the regulators should be able to see those trades. Three, data on that over-the-counter derivatives market should be aggregated and made public as we do weekly in the futures market. And fourth, stringent recordkeeping and reporting should be established for the swap dealers in these markets.

To lower risk in the market, to lower risk the administration has proposed first that the standard contracts be brought into centralized clearing. There is a very natural debate as to who that covers. Do some end users are they out of it or into it but I think that is separate from the transparency debate because everybody benefits from transparency. Secondly, swap dealers and major swap participants would explicitly have to have capital to back up what they are doing in their swap business. And third, the swap dealer should be required to post and collect margin for individual transactions. And lastly, the CFTC and SEC should be authorized to mandate robust business conduct standards to protect the market integrity, to protect against fraud and manipulation.

Over-the-counter derivatives have traditionally not been something that have any protection against fraud, manipulation and importantly to this committee, position limit authority. We have proposed and the administration has proposed that the over-the-counter energy markets, oil, natural gas and the like, also have extended position limit authority aggregate position limit authority. We support that.

I thank you for inviting me to testify today. I will be happy to answer any questions you may have.

[The prepared statement of Mr. Gensler follows:]

STATEMENT OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

HOUSE COMMITTEE ON ENERGY AND COMMERCE

SUBCOMMITTEE ON ENERGY AND THE ENVIRONMENT

December 2, 2009

Good afternoon Chairman Markey, Ranking Member Upton and members of the Subcommittee. Thank you for inviting me to testify regarding the regulation of over-the-counter (OTC) derivatives, particularly with respect to energy markets.

Last year's crisis marked a defining moment in our nation's history. The crisis was a call to action for the Administration, Congress and market regulators to ensure that we do all we can to prevent the financial system from so undermining the economy and the wellbeing of the American public. Though there are certainly many causes of the crisis, I think most would agree that the unregulated OTC derivatives marketplace played a central role.

CFTC Regulatory Regime

Before I get to OTC derivatives, I will take a moment to discuss what the CFTC does and our current oversight of energy futures.

The CFTC is responsible for regulating certain types of markets for risk management contracts, also known as derivatives. Many of these contracts, including futures on interest rates, currencies, wheat, energy and other commodities, are traded on regulated, transparent exchanges. Other types of derivatives, called swaps or over-the-counter derivatives, are traded between two parties and, for the most part, are currently excluded by statute from regulation.

With regard to the trading of futures contracts and commodity options, the CFTC has thorough processes to ensure that exchanges have procedures in place to protect market participants and ensure fair and orderly trading, free from fraud, manipulation and other abuses. Exchanges and trading venues are where buyers and sellers meet, prices are negotiated and discovered, trades are affirmed and transaction prices and volumes are reported in a timely manner.

The oversight of clearing is an integral part of the CFTC's regulatory structure. By guaranteeing the performance of contracts submitted for clearing, the clearing process significantly reduces systemic risks. Clearinghouses are different from trading venues in that they help lower risk to the parties after they enter into the trade. Through the discipline of a daily mark-to-market process, the settling of gains and losses and the imposition of independently calculated margin requirements, regulated clearinghouses ensure that the failure of one party to OTC derivatives contracts will not result in losses to its counterparties. The Commission has extensive experience and a well-established program to ensure derivatives clearing organizations and clearing firms have safeguards to ensure orderly clearing and settlement of transactions and safekeeping of customer funds.

The CFTC has wide-ranging transparency efforts designed to provide as much information about commodity futures markets and trading to the American public as possible under current law. The agency also has broad surveillance powers to police the markets for fraud, manipulation and other abuses.

Further, as directed by statute, the CFTC is currently seriously looking into whether position limits should be set in the energy markets as they currently are in many agricultural markets. In setting position limits for certain agricultural commodities, the CFTC sought to ensure that the markets were made up of a broad group of market participants with a diversity of views. Similarly, working with the exchanges, such position limits were set for energy futures as recently as 2001.

While the CFTC does not set prices, it ensures that commodity markets are fair and orderly. Futures markets not only provide critical risk management tools for oil producers, utility companies and other market participants, but they also affect the decisions families make around the dinner table. Gasoline prices, for example, can determine whether a family takes a summer vacation, and the prices of natural gas futures contracts can affect a homeowner's utility bills.

While many different federal agencies oversee the various cash markets throughout the economy, Congress determined that the CFTC should be the sole agency to oversee trading on futures exchanges. One of the principal reasons that Congress mandated this exclusive jurisdiction was to bring uniformity to the regulation of the futures markets. In doing so, the CFTC was also given the authority to provide exemptions from the agency's oversight for specific instruments or markets where it is in the public interest to do so.

The CFTC's exclusive jurisdiction over the futures markets coexists with other agencies' jurisdiction over the underlying commodities. In addition, the agency has a long history of cooperation with other agencies, including periodic joint enforcement meetings, memoranda of understanding and surveillance briefings. The Department of Agriculture, for example, regulates marketing standards for corn and cash milk prices, while the CFTC regulates corn and milk futures. The Grain Inspection, Packers and Stockyards Administration oversees livestock markets, while the CFTC regulates livestock futures. The Treasury Department oversees the issuance of all Treasury Bills, Notes and Bonds, while the CFTC oversees Treasury futures. The Federal Reserve Board oversees interest rate levels, while the CFTC oversees interest rate futures contracts. The Federal Energy Regulatory Commission (FERC) oversees many elements of the energy markets, including natural gas pipelines and electricity markets, while the CFTC oversees natural gas and electricity futures.

Regulation of Energy Futures Markets

A transparent and consistent playing field for all physical commodity futures – from agricultural products, such as corn and wheat to energy products, such as crude oil and natural gas – should be the foundation of our regulations. The CFTC has a long history in the oversight of the futures markets for energy commodities. The agency currently oversees the trading of futures and options on futures on crude oil, heating oil, natural gas, gasoline and electricity, among others, traded on designated contract markets (DCMs), such as the New York Mercantile Exchange (NYMEX), and on some exempt commercial markets (ECMs), such as the Intercontinental Exchange (ICE) and the Nodal Exchange.

Energy futures are a large and vibrant market and important to the American economy. In the first ten months of 2009, more than 315 million energy futures and options contracts were traded on CFTC-regulated exchanges. The largest contract in crude oil by volume was NYMEX's West Texas Intermediate crude oil contract with 114 million contracts. That is the equivalent of 114 billion barrels of oil, with a notional value of nearly $7 trillion. The largest contract in natural gas was NYMEX's Henry Hub natural gas contract with 38 million contracts. That is the equivalent of 380 billion mmBTU's of natural gas with a notional value of $1.6 trillion. Energy futures markets also include very significant trading in electricity contracts, which, as a class, had more than 23.5 million contracts traded representing 7.5% of the overall volume in the energy sector.

Congress has continued to reaffirm the CFTC's role in regulating futures markets. In last year's Farm Bill, Congress strengthened the CFTC's authority over certain energy derivatives trading. Under the Farm Bill, if a contract that is traded on an exempt commercial market (ECM) is found to perform a significant price discovery function, the ECM is subject to heightened regulation and required to comply with key core principles that also apply to the trading of futures contracts.

In July, the Commission issued an Order finding that the ICE Henry LD1 Fixed Price Contract traded on the Intercontinental Exchange (ICE) serves a significant price discovery function. This ICE natural gas contract is cash settled based on the final settlement price of the NYMEX Henry Hub-based futures contract. The CFTC has sought public comment regarding determinations whether more than 40 additional energy contracts, including natural gas and electricity contracts that are currently traded on exempt commercial markets, are significant price discover contract as mandated in last year's Farm Bill.

OTC Derivatives Regulation

I will now discuss much-needed regulatory reform of the OTC derivatives marketplace. Derivatives play an enormous role in our economy. The total value of derivatives traded in the United States is based on a dollar amount nearly 20 times the size of our economy. The arithmetic would suggest that, on average, a $50 tank of gas could have as much as $1,000 in derivatives behind it.

OTC derivative transactions currently occur out of sight of federal regulators and out of sight of market participants. As Congress pursues regulatory reform of OTC derivatives, two principal goals are key: promoting transparency of the markets and lowering risk to the American public.

Improving Transparency

Economists have for decades recognized that transparency benefits the marketplace. After the last great financial crisis facing the nation, President Roosevelt called for transparency in the futures and securities marketplaces. It is now time to promote similar transparency in the OTC derivatives marketplace.

Lack of regulation in these markets has created significant information deficits:

- Information deficits for market participants who cannot observe transactions as they occur and, thus, cannot benefit from the transparent price discovery function of the marketplace;
- Information deficits for the public who cannot see the aggregate scope and scale of the markets; and
- Information deficits for regulators who cannot see and police the markets.

To address information deficits in the OTC derivatives markets, both for energy derivatives as well as non-energy derivatives, the Administration has proposed – and we support – the following priorities:

First, all standardized OTC derivative transactions should be moved onto regulated transparent exchanges or trade execution facilities. This is the best way to address information deficits for market participants. Customized transactions that are so tailored that they are not able to be cleared or listed on an exchange should be allowed, but dealers should be subject to comprehensive regulation. Such transparency greatly improves the functioning of the existing securities and futures markets. We should shine the same light on the OTC derivatives markets.

Increasing transparency – including a timely consolidated reporting system – for standardized derivatives should enable both large and small end-users to obtain better pricing on standardized and customized products. Corporate treasurers across America would find access to trading screens would greatly benefit their ability to determine the best price and hedge their risk. A utility company, for example, could better decide whether or not to purchase natural gas derivative contracts based upon the reported pricing from exchanges. As customized products often are priced in relation to standardized products, mandated trading through transparent trading venues should benefit all end-users, whether trading with standardized or customized swaps. Just as transactions involving end-users are not exempt from trading on existing stock or futures exchanges, all standard contracts should be brought to transparent trade execution facilities.

Second, all transactions that do not occur on trading platforms should be reported to a trade repository that makes the data available to regulators. This will complement regulators' ability to obtain transaction data on trades conducted through a transparent trading venue. U.S. regulators and foreign regulators should both have unfettered access to see all transactions, regardless of whether the physical locations of the trade repositories and clearinghouses are in the United States or elsewhere.

Third, data on OTC derivatives transactions should be aggregated and made available to the public. The CFTC currently collects and aggregates large trader position data and releases it to the public. We should apply the same transparency standards to OTC derivatives. This will promote market integrity and protect the American public.

Fourth, stringent recordkeeping and reporting requirements should be established for swap dealers and major swap participants and vigorously enforced. This should include an audit trail so that regulators can guard against fraud, manipulation and other abuses. Regulators also should have the authority to set aggregate position limits in the OTC markets.

Lowering Risk

To lower risk to the American public from the OTC derivatives markets, the Administration proposed – and we support – four essential components of reform.

First, standard OTC transactions should be required to be cleared by robustly regulated central counterparties. Currently, trades mostly remain on the books of large complex financial institutions. These institutions engage in many other businesses, such as lending, underwriting, asset management, securities, proprietary trading and deposit-taking. Clearinghouses, on the other hand, are solely in the business of clearing trades. To reduce systemic risk, it is critical that we move trades off of the books of large financial institutions and into well-regulated clearinghouses. Dealers that enter into customized transactions that are not subject to a clearing requirement should be required to meet heightened capital standards. This would allow end-users to hedge using tailored transactions while limiting risk to the system.

I believe that all clearable transactions should be required to be brought to a clearinghouse, regardless of what type of entity is on either side of the trade. This would remove the greatest amount of risk arising from the interconnectedness of large financial institutions.

If Congress decides, however, to exempt transactions with some end-users from a clearing requirement, that exception should be explicit and narrow. It is most critical that transactions with financial firms – and in particular, hedge funds and other investment funds – benefit from a clearing requirement. These entities are responsible for a substantial share of the OTC derivatives market and they are capable of meeting these requirements. Even though individual transactions with a financial counterparty may seem insignificant, in aggregate, they can affect the health of the entire system. Moreover, to the extent that any firms are excluded from the clearing requirement, those firms will be left unprotected in the event that a swap dealer or major swap participant is unable to perform its trades. The clearing requirement serves to protect the firm that is required to clear its trades as well as its counterparties. Thus, even if the statute does not require clearing, end-users should have the option to bring their trades to regulated clearinghouses. Furthermore, any exemptions for end-user transactions from a clearing requirement should not also exempt those transactions from a transparent trading requirement.

Second, swap dealers and major swap participants should have sufficient capital. Capital requirements reduce the risk that losses incurred by one particular dealer or the insolvency of one of its customers will threaten the financial stability of other institutions in the system. While many of these dealers, being financial institutions, are currently regulated for capital, we should explicitly – both in statute and by rule – require capital for their derivatives exposure. This is particularly important for nonbank dealers who are not currently regulated or subject to capital requirements.

Third, swap dealers should be required to post and collect margin for individual transactions. Margin requirements reduce the risk that either counterparty to a trade will fail to perform its obligations under the contract. This would protect end-users of derivatives from a dealer's failure as well as guard dealers from end-users' failures. End-users should be permitted to enter into individualized credit arrangements with the financial institutions that transact on their behalf, with the option of posting noncash collateral, to meet a clearing requirement.

Fourth, the CFTC and SEC should be able to mandate robust business conduct standards to protect market integrity and lower risk. Business conduct standards should ensure, among other things, the timely and accurate confirmation, processing, netting, documentation and valuation of all transactions, as well as protect against fraud, manipulation and other abuses.

To accomplish these principal goals of promoting transparency and lowering risk, we must bring comprehensive reform to the entire OTC derivatives marketplace. Statutory exemptions can undermine that goal and, as we have seen, could leave the public exposed to unintended consequences.

Closing

One year ago, the financial system failed the American public. The financial regulatory system failed the American public. We must now do all we can to ensure that it does not happen again. While a year has passed and the system appears to have stabilized, we cannot relent in our mission to vigorously address weaknesses and gaps in our regulatory structure. We have a profound responsibility to address the causes of the last crisis and work to prevent the next one.

I thank you for inviting me to testify today. I look forward to working with you in the coming months to implement comprehensive reform of our financial regulatory system. I will be happy to answer any questions you may have.

Mr. MARKEY. Thank you, Chairman Gensler, very much for being here.

The chair will recognize himself for a round of questions.

Chairman Wellinghoff, the House Agriculture Committee has passed legislation dealing with the subject of derivatives which has an impact on the FERC. Could you tell us in your opinion, what is the worst case scenario that could result from the passage of the House Ag Committee bill without modification?

Mr. WELLINGHOFF. I think the worst case scenario is one that has been discussed some by some of the members in their opening remarks. If the swaps in that bill are considered to be the exclusive jurisdiction of the CFTC and interpretive to include products in the RTO markets to the extent that we in fact can't regulate and we can't design and develop those markets in ways that ultimately can ensure functioning, I think it would be virtually impossible for us to ensure that those markets are producing just and reasonable rates, and we talked about one set of products there. There has been some discussion of something called FTRs, Financial Transmission Rights but that is just one example. There will be a number of other products that are going to be necessary to do things like bringing demand response into the markets, to bring in wind and other renewables into the markets. All those products are ones that will be functioning fully as an integrated whole in the RTO markets and if we in fact can't have authority and jurisdiction over them and instead the CFTC has that authority, then I think it is likely that those products cannot be fully developed and integrated in a way that will allow us to do things like bring in new renewables, bring in the demand side of the markets.

Mr. MARKEY. So if the FERC lost jurisdiction over these products which are created under the authority of the FERC, would the FERC then have to consider not allowing for the issuing of those products?

Mr. WELLINGHOFF. Well, certainly ultimately we could close down the markets and go back to cost-based regulation but I don't think anybody wants us to do that because I think markets ultimately will produce the efficiencies that we need to move forward towards a low-carbon future. So that is what I am looking for, the ability to have those markets be flexible, open, transparent and operated in a way that the FERC can ensure that they do produce just and reasonable rates.

Mr. MARKEY. Chairman Gensler, how can we avoid that outcome?

Mr. GENSLER. Well, Chairman Markey, I believe that the CFTC as it coexists with other Federal regulators whether it is the Agriculture Department or FERC today can continue to coexist and we have had good productive meetings with you and Chairman Waxman and your staffs and Chairman Peterson on this very issue in the last several days. I think that we need to bring broad reform to the over-the-counter derivatives market. Neither agency currently oversees the over-the-counter derivatives market. Neither agency currently oversees the over-the-counter derivatives for natural gas, electricity, fuel oil or any energy product today. We need to bring that into these marketplaces but at the same time as you say to work together with FERC and with your committee staff to ensure that the public is best protected and we continue to coexist and promote the public interest.

Mr. MARKEY. Well, analyzing the kind of job that the FERC does right now overseeing these markets, do you see any gap in the work that they do, any underappreciation of dangers that exist in the marketplace that the FERC is not observing?

Mr. GENSLER. Well, I wouldn't want to comment on FERC and all of its authorities. They, of course, are very important to the American public ensuring just and reasonable rates as the chairman said and as a rate regulator. Our domain is more as a market regulator to promote market integrity of these derivative marketplaces and so I think each of us right now do not oversee the over-the-counter derivatives marketplace and that is a gap to the American public.

Mr. MARKEY. Chairman Wellinghoff, much of your testimony focuses on the potential for the bill approved by the House Ag Committee to harm RTO markets and mechanisms used in those markets to ensure just and reasonable prices such as Financial Transmission Rights or Forward Capacity Markets but isn't there also a risk that this bill could also limit your ability to approve these or other mechanisms in a non-RTO market as well?

Mr. WELLINGHOFF. Well, we certainly maintain that we don't have regulatory oversight authority per se of the other markets beyond the RTOs but we do believe that the authority that you gave us in 2005 with respect to fraud and manipulation allows us to look at those participants in those other markets and to the extent they are acting in those other markets in ways that we determine to be engaging in fraud and manipulation that can, in fact, affect the cash markets and the RTOs that we oversee, we believe we have jurisdiction over that. We want to preserve that as well. We think that is absolutely essential to ensuring that our ability to stop fraud and manipulation in the electric markets and the gas markets we have to have that ability to look into those other areas.

Mr. MARKEY. Thank you, Chairman Wellinghoff, very much and I just want to say to you, Chairman Gensler, your testimony here back in 1998 was very instrumental in ensuring that there was strong privacy protections in what became known as the Gramm-Leach-Bliley bill. Almost all of the privacy protections emanated from this committee and your testimony helped enormously and for us to be able to do that.

Mr. GENSLER. Well, I thank you. I remember working well with you then. I look forward to working with you well to bring reform to the over-the-counter markets here as well.

Mr. MARKEY. We appreciate that, sir, thank you.

The chair recognizes the ranking member, Mr. Upton.

Mr. UPTON. Thank you. Thank you very much.

Chairman Wellinghoff, the Energy Policy Act of '05 gave FERC the anti-manipulation authority over electric and natural gas markets as you know and one of the reasons I had supported the bill I thought it was a good provision. Could you give us some examples in which FERC has used the authority to protect consumers over the last couple of years?

Mr. WELLINGHOFF. I would be happy to. Thank you.

The Commission settled two major manipulation cases in 2009, Amaranth and ETP. We also analyze other cases and concluded in those that manipulation didn't occur but we opened over 100 investigations between 2007 and 2009, and an increasing percentage of those are for investigations in market manipulation. In fact, 70 percent of the investigations opened in fiscal year 2009 were for market manipulation specifically and in 2009, we recovered $39 million in penalties and $38 million in disgorgement so we have acted extensively under that authority that you gave us in 2005.

Mr. UPTON. Great. I know this is—a number of us sent a letter to the Speaker. I don't know if you saw this letter. It was dated yesterday. I don't know if you saw it or not. You haven't seen it. That is correct, sir. Have you heard about the letter?

Mr. WELLINGHOFF. Just now.

Mr. UPTON. Well, let me, all right, sorry. The Chairman Markey outlined in his opening statement what might be a reasonable compromise at least from this committee's standpoint as you heard the opening statements from both sides here as to a process that might be able to work. I think it is all of us at least that I have heard this afternoon have indicated that I think the underlying bill does not provide that at all and something that Chairman Markey outlined where you would actually define responsibilities. FERC would in fact take sole responsibility on a number of those issues might be something that this committee, subcommittee could support as compared to the underlying bill.

Mr. Gensler, I don't know if this is the first that you have heard of that. It sounds like there have been some discussions. Is that an approach that you think the CFTC could accept and support?

Mr. GENSLER. There have been constructive discussions with the chairman directly—both chairs and their staffs and Chairman Peterson from the House Agriculture Committee and his staff—so I think those have been constructive dialogs. There has been no resolution. I did want to comment one thing about the as I understand it on the manipulation standards that were raised by a number of members in their opening statements. I believe you did, as well, Representative Upton, but from what I understand there is nothing in this swaps bill, the 3795 or as the administration proposed it that would affect FERC's anti-manipulation authority as outlined in the 2005 Act over its markets, the markets that they oversee, the natural gas and the electricity markets as you so well put into that bill in 2005. I think what we have been talking a lot with the committee about is this issue of how we coexist. How the CFTC as a market regulator oversees futures and derivatives while very important functions that FERC oversees the electricity and natural gas market is, you know, for just and reasonable rates in the electricity markets is and so forth. How we coexist and bring the best to the American public particularly the thing that has been at the focus is these Financial Transmission Rights that have been raised by a number of members.

Mr. UPTON. Mr. Wellinghoff, I know that you have not been chairman of FERC for all that long but if you look back to when we gave FERC the authority in the Energy Policy Act of '05, are there things that FERC might have done differently in terms of the role that they have played?

Mr. WELLINGHOFF. I am not sure that there are things that we could have done differently. Fortunately, you will have another FERC chairman before you later on. Betsy Moler will, former FERC chairman, so you might want to ask that question to her as well but I give Betsy a little question. Certainly I will tell you that that authority in 2005 was tremendously helpful to us with respect to the ability to go in and investigate fraud and manipulation and ensure that it wasn't ongoing. I think FERC prior to 2005, did have some tools in its toolbox. I am not sure that they used them all to the extent that they should have but I am not going sit here post-judging a prior Commission or prior chairman but certainly in hindsight, there are probably some things that could have been done. I can't give you any specifics though.

Mr. UPTON. Time has expired.

Mr. MARKEY. Gentleman's time has expired.

The chair recognizes the chairman of the full committee, Mr. Waxman.

Mr. WAXMAN. Thank you, Mr. Chairman.

In 1999, Californians paid $7.4 billion for wholesale electricity. A year later, those costs rose 277 percent to $27.1 billion so it was clear these prices were the result of deliberate market manipulation and fraud that gave rise to the legislation that has been referred to a number of times. Now, Chairman Gensler, you just said you don't think that the bill would interfere with FERC enforcing that law, is that your position?

Mr. GENSLER. As I understand it the 2005 Act which granted the anti-manipulation authorities that have been referred to by many members, I am not aware of something in 3795, nothing in that swaps bill that I am reading carefully because the general counsel for the CFTC wrote this but that it wouldn't affect FERC's anti-manipulation authority under that Act over the markets that they oversee. As you mentioned the electricity crisis, I do think that one of the important lessons out of the Enron crisis and the electricity crisis which was then, you know, complemented in a bad way with this terrible crisis last year is that we have to bring reform to the entire over-the-counter derivatives market and not have an exception for instance for some part of the over-the-counter derivatives marketplace.

Mr. WAXMAN. I don't disagree that we need regulation in light of the experience we have had where there was no cop on the beat in these over-the-counter trades but as I read H.R. 3795, I think there is a very good chance that RTO products and services regulated under FERC approved rules would fall under the definition of a swap and that means that CFTC would have exclusive jurisdiction over these products and services. You don't think it means that. Would you disagree with the idea of a clarification that FERC's jurisdiction is not being intruded upon?

Mr. GENSLER. Well, I think that is what we are working with you and Chairman Markey and Chairman Peterson, hopefully productively on. I do think that the CFTC has an important role to play as a market regulator over derivatives products to ensure market integrity and market transparency and FERC has a very important public role to play.

Mr. WAXMAN. If market manipulation or fraud occurred in a FERC regulated marketplace under CFTC's jurisdiction, would the exclusivity clause of the Commodities Exchange Act prevent FERC from exercising its anti-market manipulation authorities? In other words, would FERC regulation be displaced by CFTC regulation? You don't think so but that is what we are concerned about. I think it needs to be clarified if you don't think—if you agree with us.

Mr. GENSLER. Well, I think that anti-manipulation standard that you put in place in the '05 Act which talked about in connection with the physical markets that the natural gas markets and the electricity markets. Similar to how we coexist with the Agriculture Department that has many authorities in the agricultural markets.

Mr. WAXMAN. Well, you coexist now with FERC, right?

Mr. GENSLER. Yes.

Mr. WAXMAN. OK, so the question is well, let me ask Chairman Wellinghoff, what do you think of the possibility given that this swap is defined that they may just—some court may come along and say well, either you both have the regulation or they have exclusive regulation?

Mr. WELLINGHOFF. I think it is a definite concern. Not only a concern but it is a looming one in that in the Amaranth case that we have in part pending, part of that case is still pending. One of the parties was not let out of the case and we are moving forward with it but in that case the CFTC was arguing in court that FERC did not have jurisdiction in the financial markets so it is already cloudy and I think all we are doing is moving in the other direction here with this legislation of making it more cloudy or more certain that the exclusive jurisdiction is on the CFTC side. So we need to ensure that FERC has the ability to go in and do the investigation and have the jurisdiction over the parties that are engaged in the manipulation and fraud, otherwise we can't do our job.

Mr. WAXMAN. Well, the financial reform legislation is important because the financial meltdown demonstrated that there were significant regulatory gaps but the RTO markets are comprehensively regulated by FERC and we need to make sure that we don't unintentionally roll back important protections against market manipulation and fraud that are already in the law. And as I pointed out as a Californian, the reason that law was changed was to plug up the gap and we filled that gap very clearly by designating FERC as the agency to be responsible. I don't want us now to plug up another gap in regulatory authority by confusing FERC's jurisdiction. Yes, Chairman Gensler.

Mr. GENSLER. I was just going to say actually neither agency right now have jurisdiction over a transaction between a large financial house and a utility company called an over-the-counter derivative in natural gas, heating oil, electricity. Where FERC has very clear jurisdiction on the RTOs and to protect the public, where we have very clear jurisdiction on something called a futures market like NYMEX or this Intercontinental Exchange, we do have some pretty good authorities and we coexist but there is a whole world out there, trillions of dollars notional amount. What I quoted big numbers the over-the-counter market is bigger and that is where we want to regulate the dealers to lower risk and promote transparency to the American public and I think we can continue to coexist and work with your staffs to make sure that the FERC doesn't inadvertently or unintentionally be less able to protect the public.

Mr. WAXMAN. It is not that we are trying to protect FERC. We are trying to make sure the regulation makes sense and it makes sense for you to regulate futures and but it makes sense for FERC to regulate the manipulation of the markets, and there may be some ambiguity down the line. What do you think ought to be done then? I suppose you two ought to get together and figure it out but we ought not to start with a law that is so ambiguous that neither of you will regulate or both of you will regulate. And then it seems to me, Chairman Wellinghoff, if the chair would permit just one last thing. What do you think the impact would be on the energy markets if there are two regulators they have to respond to?

Mr. WELLINGHOFF. Well, uncertainty in the markets creates more risk and it creates more cost, and we have seen that over and over and that would be the result.

Mr. WAXMAN. Thank you. Thank you, Mr. Chairman.

Mr. MARKEY. Gentleman's time has expired.

The chair recognizes the gentleman from Louisiana, Mr. Scalise.

Mr. SCALISE. Thank you, Mr. Chairman.

Chairman Gensler, if you have done an analysis on the legislation can you talk about any kind of impact that you have assessed that it would have on energy prices or on energy products?

Mr. GENSLER. I think that the legislation if able to pass with strong transparency initiatives where utility companies whether small or large could clearly see where this market trades on a real time basis that helps to lower cost. Right now this market has a significant information deficit, where Wall Street benefits and Main Street loses out frankly, and that is because that small utility company or large utility company can't see on a real time basis the trades in the over-the-counter natural gas marketplace, the over-the-counter coal marketplace, the over-the-counter electricity marketplace. They can see a lot of transparency on a futures market or on some of the markets that FERC regulates but not on these over-the-counter so I think that helps in a significant way. It would also lower the cost to the American public of the crisis that could come when large financial institutions concentrate so much risk when they keep these trades on their books.

Mr. SCALISE. All right and we have talked about the large financial institutions and the problem they have and the concern that those of us that have opposed this bill have is that it is not necessarily the large folks who actually did the damage. It is the small guys who played by the rules that would be hurt by this and with that I would ask, Mr. Wellinghoff, you talked about in your testimony you actually used the term harmful to consumers. If you can expand on, you know, kind of your take on how this legislation would be harmful to consumers.

Mr. WELLINGHOFF. Harmful in the sense that if we had two regulators in the space and the industry and the participants in that market were uncertain as to the clarity of that regulation which they certainly could be if you had two regulators with conflicting positions. Ultimately you are going to increase cost because you are going to do two things. Number one, you are going to increase the cost of equity because risk is going to be increased and number two, you are going to increase regulatory costs as well. So both of those, all of those costs the consumer pays for everything. All of those costs are ultimately going to go to the consumer. Now, I haven't quantified it and I am willing to accept former Chairman Moler's numbers that she has presented in her testimony but we haven't done a specific quantification.

Mr. SCALISE. OK and then, Chairman Gensler, would there be more systemic risk if companies chose not to hedge their risk and, you know, they just thought that the cost would be prohibitive?

Mr. GENSLER. Congressman, hedging is a very important part of our economy. We are promoting that in this bill. We are lowering risk to the American public allowing utilities and energy companies to hedge customized risk but those risks that are standard enough, for instance a 2-year risk on natural gas pricing, standard contract, we want to move that onto the clearinghouses to lower risk and very importantly on the transparent trading venues. And if I might note, I don't think the transparency costs end users. If you didn't know what an apple cost when you walked in the store, does it help you if you have to pay an extra nickel or 10 cents for that apple because you don't know what it cost the prior person walking in the store? I don't think so. We bring every securities transaction and every futures transaction to transparent markets. Why shouldn't we do that in natural gas and electricity over-the-counter markets?

Mr. SCALISE. Chairman Wellinghoff, you had mentioned that one of FERC's responsibilities is to ensure that consumers have adequate supplies of energy at reasonable prices.

Mr. WELLINGHOFF. Correct.

Mr. SCALISE. How important is it to you that the responsibility as a core tenet of energy regulatory system is ensuring that reasonable prices exist for consumers?

Mr. WELLINGHOFF. Well, it is essential and the only way to have reasonable prices with these RTO markets is to ensure that they are well-designed as a structural package and that is why it is so important to have one entity who oversees that structural package to make certain that the design is adequate to ultimately get to the end result of the reasonable prices.

Mr. SCALISE. OK and then you had also talked about or I think in your testimony, the intensive capital expenditures, just the energy industry as a whole is a capital-intensive industry. Could you comment on the role that the FERC regulated financial products play in securing capital for the development of new technologies and if that capital is limited by new regulations, what that role would be on the ability to have newer technologies developed?

Mr. WELLINGHOFF. Certainly, with respect to recovery of investment like in transmission to the extent that those entities are not able to recover their full investments, they are not going to invest in new technologies, the newest market that we need to ultimately move us into the next phase of where we need to go with respect to our energy futures.

Mr. SCALISE. Thank you and I yield back.

Mr. MARKEY. Gentleman's time has expired.

The chair recognizes the chairman emeritus of the committee, Mr. Dingell.

Mr. DINGELL. Thank you.

Mr. MARKEY. Mr. Chairman, could you move the microphone over a little?

Mr. DINGELL. Right, the legislation would make energy hedging and trading subject to CFTC's exclusive jurisdiction and require that all of these transactions be cleared and traded on exchanges. FERC would lose jurisdiction. First of all, of what would you lose jurisdiction?

Mr. WELLINGHOFF. As I understand it we would lose jurisdiction over these markets and their operation ultimately.

Mr. DINGELL. What would you be able to do with regard to an RTO that you wanted or with regard to an RTO that wanted to put in some carrying capacity? What would happen with regard to your efforts with regard to dealing with fraud or market manipulation? If you couldn't get at the derivative and you couldn't inquire into the derivative, how would you then be able to conduct a meaningful and complete investigation in those two instances?

Mr. WELLINGHOFF. Our hands would be tied.

Mr. DINGELL. I am sorry.

Mr. WELLINGHOFF. Our hands would be tied.

Mr. DINGELL. Your hands would be tied. Now, where else would your hands be tied by that provision?

Mr. WELLINGHOFF. In creating new products for these markets as I mentioned by moving forward into things like renewables and energy efficiency demand response we are starting to put the demand side into these markets. It has never been done before. It is just starting to over the last couple of years.

Mr. DINGELL. And so the derivatives that would finance this you would not be able to go into?

Mr. WELLINGHOFF. That is correct.

Mr. DINGELL. And so you would not have any way of knowing whether you had a successful investigation or rulemaking or ratemaking procedure, is that right?

Mr. WELLINGHOFF. That is possible, yes.

Mr. DINGELL. All right, I would—I am going to submit and ask unanimous consent that I be permitted to submit a letter to the Commission following up with some of these questions.

Mr. MARKEY. Without objection, so moved.

Mr. DINGELL. Now, what is the problem here, Mr. Wellinghoff, with regard to the situation which brings about this legislation requiring us to force all of the derivatives into exchanges and what authority do you lack to address these questions?

Mr. WELLINGHOFF. I think the issue as I understand it is again to the extent that the definition of swaps in the legislation could intrude into the RTO markets it would in fact take away our ability to develop and shape these markets in ways that can ensure that rates are just and reasonable.

Mr. DINGELL. You wouldn't understand the underlying financing and you would have no power whatsoever to go into those questions, is that right?

Mr. WELLINGHOFF. That is correct.

Mr. DINGELL. All right, now, FERC has stated in its State of the Markets report that natural gas and related electricity costs in the U.S. were driven up in 2008, by flows of funds in the derivatives and financial products such as futures and swaps at a time when there was adequate inventories of natural gas. Did the CFTC do an adequate job of regulating excessive speculation at that time?

Mr. WELLINGHOFF. I would suggest you ask Chairman Gensler that question.

Mr. DINGELL. The answer is what?

Mr. WELLINGHOFF. I would suggest you ask Chairman Gensler that question.

Mr. DINGELL. OK now, Mr. Gensler, did you do a good job of regulating those matters at that time?

Mr. GENSLER. It is good to be back before you, Representative Dingell.

Mr. DINGELL. Let us talk about your agency. Did it do an adequate job? The answer to that question is no is it not?

Mr. GENSLER. I keep calling you chairman I know because if I am allowed to, Chairman Emeritus, I came onto the agency in May of this year.

Mr. DINGELL. I don't want to do that. Did the agency do an adequate job in 1 minute and 20 seconds?

Mr. GENSLER. And what I found is the staff in the agency is very strong and what we have done is we have taken a serious look at bringing back, we have had position limits at the energy space until June of 2001, working with the exchanges. We are looking seriously about bringing them back. I also just wanted to comment.

Mr. DINGELL. So your answer is you did not do an adequate job? Now, given FERC's pervasive regulation of RTO and ISO markets is there a regulatory gap in those areas that must be filled by the CFTC and if so, what is it?

Mr. GENSLER. I think there is a significant regulatory gap right now in what is called over-the-counter derivatives. Transactions that are not on a RTO, they are transactions between.

Mr. DINGELL. Require you to have legislation that excludes the FERC in its entirety from jurisdiction over those kinds?

Mr. GENSLER. Currently, the CFTC has exclusive jurisdiction over futures markets and that is whether it is on NYMEX or and so forth and I don't think there is any dispute here between our agencies here on that.

Mr. DINGELL. But your legislation here would say to it that there could be no inquiry into those matters whatsoever by FERC?

Mr. GENSLER. It is not, with all respect that is not how we read.

Mr. DINGELL. Let me finish.

Mr. GENSLER. I am sorry.

Mr. DINGELL. That benefit by depriving FERC of any authority to address those questions which might lie under its concern?

Mr. GENSLER. Our read of 3795, it does not affect that which you put in place in 2005, and in fact there has been an exclusion from our statute since the 1930s that we don't regulate what we call forwards, spot markets or forward markets, what some people call the cash market so the day ahead market and the electricity market all of these are not.

Mr. DINGELL. That is splendid but not responsive. I would like to hear what CFTC has done to prosecute the excessive speculation that was cited in the FERC State of the Market report regarding natural gas and electricity prices be driven up by flows of funds into derivatives. What have you done about that?

Mr. GENSLER. We have a very strong and robust enforcement agency that would bring numerous cases. In fact, the Amaranth case that was earlier referred to we both brought and settled, and Jon and I met on that in a very constructive way. We have had their enforcement people working with ours and our enforcement people working with FERC I think in a very constructive way and have a memorandum on understanding which we can build upon.

Mr. DINGELL. Now, if you please, Mr. Wellinghoff, please tell us how you will be able to carry out your mission with regard to making the RTOs work, deal with the supply problem, deal with all of your other responsibilities if you don't have authority to get into the derivatives which are a major part of the financing of all of these apparitions?

Mr. WELLINGHOFF. I won't with certainly with respect to fraud and manipulation. I need that authority, continue to have that authority to ensure that there is no fraud and manipulation.

Mr. DINGELL. Thank you. Thank you, Mr. Chairman.

Mr. MARKEY. We thank the chairman.

The chair now recognizes the gentleman from Oregon, Mr. Walden.

Mr. WALDEN. Thank you very much, Mr. Chairman, and thank you for holding this hearing on this important legislation.

Mr. Wellinghoff, I want to ask you, I have some concerns regarding the clarity of H.R. 3795 as to whether it would impact the operation and cost of the Federal power marketing administrations and customers? As you know, I am from the great northwest, the State of Oregon and we do things and we don't necessarily operate under an RTO but Bonneville has its own trading floor and so I am curious from both of you on how this your take on this legislation and its effect there and, Mr. Wellinghoff, you can start and then maybe, Mr. Gensler, if you could comment, as well.

Mr. WELLINGHOFF. Congressman Walden, quite honestly I haven't looked at it from that perspective so I don't really want to give you a view, you know, from off the top of my head. I mean there may be some collateral affects but I really haven't analyzed it.

Mr. WALDEN. Mr. Gensler.

Mr. GENSLER. Again, I am not aware of any but we would be glad to work with you and your staff as we are working with Chairman Markey.

Mr. WALDEN. I think one of the issues that has been raised is that this should be clear it doesn't cover the physical delivery of commodities such as electric power and gas, and is that clear?

Mr. GENSLER. That is right just as in the Commodities and Exchange Act for 70-some years it has not only excluded the physical delivery but also the forward markets that is excluded. Similarly 3795 and the administration would exclude the forward, these day-ahead markets and so forth.

Mr. WALDEN. And, Mr. Wellinghoff, do you concur with that analysis?

Mr. WELLINGHOFF. Yes.

Mr. WALDEN. So it is clear that real time day-ahead turn markets for physical delivery power and gas are not included in coverage of this bill?

Mr. GENSLER. That is as we understand it as well some of the other forward markets that are well, you know, regulated elsewhere. Anything that has a forward market and has a physical delivery is out.

Mr. WALDEN. OK, then I just want to ask about your concern again raised to me by folks who operate in these markets about the concern about restriction of capital and limited ability to hedge under this legislation and from a power perspective, from FERC's perspective maybe first, what sort of concerns are you hearing? What sort of concerns do you have about this notion that it could restrict capital and limit the ability for some of these concerns to hedge?

Mr. WELLINGHOFF. People that do hedge certain products in these markets, utilities primarily, their fuel have expressed concerns to me.

Mr. WALDEN. Right.

Mr. WELLINGHOFF. Again, I haven't quantified the affect. I think probably again the testimony of former Chairman Moler goes into that in some great detail and actually does some quantification there that might be helpful to you.

Mr. WALDEN. OK.

Mr. GENSLER. I think, Congressman, commercial hedgers have raised two concerns. One is could they enter into commercially needed but particular tailored transactions that aren't standard and the answer is an unambiguous yes but that is a legitimate question they have raised. Some members of the Senate or the House might feel differently but the administration says yes. Two is on the standard contracts they have raised the question is how is credit priced in there? Will they have to post collateral if it is lowering risk to a clearinghouse?

Mr. WALDEN. Right.

Mr. GENSLER. There is some like myself, I believe that standard transactions should be brought to a clearinghouse to lower risk to the American public but there is a legitimate public policy debate whether end users, commercial hedgers using these transactions are exempted. The 3795 does exempt them. I have called that they not be exempted and so that is the public policy debate there. I think even if Congress exempts this commercial end users from the clearing requirement, we should not inadvertently exempt them from the transparency. We can separate that. Congress can write the law that the large financial houses have to bring it into a trading venue and then everybody gets the benefit of transparency and then you sidestep the clearing issue.

Mr. WALDEN. All right, thank you, Mr. Chairman, that is all the questions I have.

Mr. MARKEY. Gentleman's time has expired.

The chair recognizes the gentleman from Michigan, Mr. Stupak.

Mr. STUPAK. Thank you, Mr. Chairman.

Mr. Wellinghoff, Mr. Dingell indicated that your State of the Markets report and that report strongly indicated a lack of physical market fundamentals was used in determining the price of natural gas and electricity, and the conclusion was that large pools of capital flowed into these various financial instruments that turned the commodities like natural gas into investment vehicles as opposed to providing a product there. Does that accurately reflect FERC's current position that financial speculation in the natural gas market has increased prices?

Mr. WELLINGHOFF. We believe it did at that time. That was one reason we went after Amaranth.

Mr. STUPAK. Do you believe that is still going on now and we have seen 100 percent increase in the price of natural gas while supplies are more than adequate.

Mr. WELLINGHOFF. Actually, natural gas prices have gone down substantially.

Mr. STUPAK. I meant gasoline. You are right, natural gas.

Mr. WELLINGHOFF. Natural gas and that is what we focus on is natural gas.

Mr. STUPAK. Right.

Mr. WELLINGHOFF. So I don't believe it is occurring now.

Mr. STUPAK. OK, do you believe that natural gas—so you think natural gas has leveled out then? It is not continuing to be distorted at all?

Mr. WELLINGHOFF. We have a lot of different dynamics going on in natural gas right now. There has been a tremendous amount of new shale finds in this country and technology to develop those shales. Shales, as well, can be more easily shut-in then traditional wells and brought back up much quicker so that dynamic is going to affect the market, that technological and that resource dynamic is going to have a big affect on the market.

Mr. STUPAK. You mentioned Amaranth a couple times and Mr. Gensler has also too, that started what in about 1995 when you first, when Amaranth started to break? When did you start really getting into Amaranth?

Mr. WELLINGHOFF. I believe it was 2006–2007, actually.

Mr. STUPAK. 2006, OK, were you going to bring a cease and desist that stopped the transaction or restraining order?

Mr. WELLINGHOFF. We do not have cease and desist authority.

Mr. STUPAK. Is that something you need to?

Mr. WELLINGHOFF. It would be helpful.

Mr. STUPAK. I mean on Amaranth that was like $6 billion, wasn't it?

Mr. WELLINGHOFF. Yes, it would have been extremely helpful in that case.

Mr. STUPAK. And what have you been able to recover?

Mr. WELLINGHOFF. We have recovered $7 and a half million.

Mr. STUPAK. $7 and a half million out of $6 billion?

Mr. WELLINGHOFF. Well, the total fund was that amount yes.

Mr. STUPAK. All right, if you had cease and desist would that assist you?

Mr. WELLINGHOFF. That would assist us tremendously, yes.

Mr. STUPAK. Mr. Gensler, let me ask you this. You made a number of statements for Congress a need to keep any end user exemption from centrally clearing swaps as narrow as possible. As the current bill is written, financial institutions have posed systemic risk to the U.S. economy are exempt from clearing swaps if they are a counter party to an end user so does CFTC have an estimate of how much of the market will be exempt from the clearing requirement because of this exemption?

Mr. GENSLER. It is a very good question. It is hard to determine because there is such a darkness in this market but it is very significant. The standard part of the market in oil and energy products may well be, the standard part of the market over half of the market is standard enough to be cleared.

Mr. STUPAK. Right.

Mr. GENSLER. But then the question is what portion of that do end users have. Now, and that is a very hard number to get but it is not in the single digit percents. I mean it is a significant portion and that is why we think at least we should do it to exchanges and if possible to clearing.

Mr. STUPAK. Well, does the CFTC then believe that tier one financial companies that pose systemic risk to the financial services industry should be exempt from centralized clearing of swaps?

Mr. GENSLER. No, I believe strongly that all swaps that are standard enough be brought into clearing and that end users be able to be allowed to do individual credit arrangements as they do now in these marketplaces and again, if Congress thinks to exempt them, let us not exempt them from the trading requirement at least.

Mr. STUPAK. Good. Well, we talked a little bit about liquidity too here today so if we allow the end users to remain exempt, would requiring tier one financial companies to centrally clear swaps on exchange regardless of their counterparty providing us liquidity in the market for pricing and hedging?

Mr. GENSLER. I think it does. I think right now these markets are internalized and there are five or six large concentrated pools of capital. They are sophisticated. Many Americans wonder as they go home for the holidays why so much money is being made on Wall Street. This is at the core of it. It is not the only reason but they internalize dark markets and I understand that but I think it is now time I believe working with Congress to bring transparency as this Congress did with President Roosevelt in the '30s to the securities and futures markets.

Mr. STUPAK. You mentioned OTC, you mentioned ICE and the Dubai market, has that been up and running now?

Mr. GENSLER. It has been very small, sir.

Mr. STUPAK. Still?

Mr. GENSLER. Yes.

Mr. STUPAK. Yet you see?

Mr. GENSLER. Well, it might develop larger but right now it has been very small. I just wanted to mention something on an earlier question.

Mr. STUPAK. Go ahead.

Mr. GENSLER. Right now these markets base, these Financial Transmission Right markets.

Mr. STUPAK. Yes.

Mr. GENSLER. From the statistics right from the PHM market, about 74 percent of their transactions are with the large financial houses, the houses you are talking about.

Mr. STUPAK. Tier one.

Mr. GENSLER. On dollar value it is apparently lower. Its transaction volume is high but over 30 percent is with the large financial houses and so they are very much participating in as speculators in these markets. They provide capital to these markets, important capital but they are part of these markets, as well.

Mr. STUPAK. Thank you, Mr. Chairman.

Mr. MARKEY. Thank the gentleman very much.

I would just like to ask one final question and then we will move to the next panel.

Ask this of Chairman Gensler, if the CFTC is doing an antifraud or anti-manipulation investigation of oil futures trading on the New York Mercantile Exchange and you believe that part of the fraudulent scheme may have involved wrongdoing in the cash market, you have the power under the Commodities Exchange Act to extend your investigation to cover that part of the fraud and you wouldn't want the Congress to deny the CFTC the power to look at transactions in both the NYMEX futures market and the cash market in your own investigation, is that correct?

Mr. GENSLER. As I understand it, our authorities are in the futures markets and that is where it starts and then if there is other attributes to this.

Mr. MARKEY. It tracks the cash market.

Mr. GENSLER. But it has got to track into the futures market because that is where our authority is.

Mr. MARKEY. But you would not want your power to track it to be constrained. You would not want your powers to track it from the futures market into the cash market to be constrained?

Mr. GENSLER. Well, I don't believe that Congress has constrained it but it has to start, it has to be in the futures market. Our whole—we are a market regulator. We don't regulate the cash markets.

Mr. MARKEY. Right, so that is but the opposite from our perspective should also be true. In other words, if the FERC finds activities in the cash market that leads it into the futures market we are basically concerned that they could be constrained in heading in the opposite direction and that is a problem that is actually being created by this legislation that we are concerned about.

Mr. GENSLER. I understand that concern. With respect, I don't think 3795 does that with the 2005 provisions, the important provisions that you provide FERC. We, of course, would not bring an action solely in the cash market. It always starts—it has got to be in the futures market where we are.

Mr. MARKEY. We would like your comments on this, Chairman Wellinghoff.

Mr. WELLINGHOFF. Well, I think you put your finger exactly on it although I am not sure that the 3795—I think 3795 may exacerbate it but the situation already exists as I mentioned. CFTC has, you know, gone into Federal court saying we can't go into the futures market in Amaranth, for example, because we don't have jurisdiction there yet. We started in the cash market. We started in the cash market. Started our action there and we were tracking it, trying to track it through into the futures market and CFTC says we don't belong there.

Mr. MARKEY. So from your perspective, you don't have a problem if the CFTC tracks it into the cash market?

Mr. WELLINGHOFF. No, problem coming to us.

Mr. MARKEY. But the CFTC has filed an amicus brief in the Amaranth case.

Mr. WELLINGHOFF. Yes, yes.

Mr. MARKEY. Saying that they don't want the FERC to be able to track from the cash market into the futures?

Mr. WELLINGHOFF. That is correct.

Mr. MARKEY. So that is a problem, it seems to me in terms of no comity there, creating comity between, you know, sister agencies, Mr. Gensler.

Mr. GENSLER. You know, I think what was done, an important thing in 2005 that you did was that in connection with the purchase or sale of natural gas or electricity are subject to the jurisdiction of FERC that they could pursue fraud and manipulation if it was in connection with the purchase or sale of natural gas and electricity in the cash markets effectively, but that Congress did not expressly in that statute in 2005 expressly say that another Federal agency should regulate in the futures market and, of course, back in 1974, Congress had adopted exclusive jurisdiction for the futures market for the CFTC to ensure uniformity and consistency in the derivatives marketplace we call futures.

Mr. MARKEY. OK, you have the last word, Mr. Wellinghoff.

Mr. WELLINGHOFF. Again, I just think there should be parody there. If they can come from the futures market into the cash market with respect to investigation, we should be able to do the same going from the cash market into the futures market.

Mr. MARKEY. I agree with you, Mr. Wellinghoff, but we thank both of you for being here and we thank both of you for working together with the committee to try to find a peaceful resolution of these issues and I think if we continue to make the progress that we have in the past couple of days that we have a good chance of doing so but it requires good faith on all parties in order to accomplish that goal.

Mr. GENSLER. Thank you, it is good to be back with you.

Mr. WELLINGHOFF. Thank you, Mr. Chairman.

Mr. MARKEY. Thank you, I thank both of you. We appreciate it. So this panel has completed its testimony. I would ask the next panel to please come up and take their seats behind their nametags.

Welcome back to this panel. This is like a hall of fame weekend here. We have a lot of, you know, longtime visitors to our committee who are returning for this very important hearing and we are going to begin by recognizing Betsy Moler who is the Executive Vice President for Governmental Affairs and Public Policy at Exelon Corporation. Prior to joining Exelon, Ms. Moler served as commissioner on the Federal Energy Regulatory Energy Commission from 1988 to 1998, including as chair from 1993 to 1998. Under her leadership, FERC issued order number 888 requiring utilities to open up their transmission lines on an equal access basis to their competitor paving the way for the development of wholesale competitive electricity marketplaces. She did that pursuant to the Markey amendment in the 1992 Energy Policy Act. We welcome you back here again, Ms. Moler. Whenever you are ready, please begin.

STATEMENTS OF ELIZABETH A. MOLER, EXECUTIVE VICE PRESIDENT, GOVERNMENT AFFAIRS AND PUBLIC POLICY, EXELON CORPORATION ON BEHALF OF THE EDISON ELECTRIC INSTITUTE; PATRICK McCULLAR, PRESIDENT AND CEO, DELAWARE MUNICIPAL ELECTRIC CORPORATION, ON BEHALF OF THE AMERICAN PUBLIC POWER ASSOCIATION; GLENN ENGLISH, CEO, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION; JOHN SHELK, PRESIDENT AND CEO, ELECTRIC POWER SUPPLY ASSOCIATION; AND VINCENT DUANE, ESQUIRE, GENERAL COUNSEL, PJM INTERCONNECTION, INC.

STATEMENT OF ELIZABETH A. MOLER

Ms. MOLER. Thank you very much, Mr. Chairman.

Mr. MARKEY. We are going to hold you to 5 minutes each of you in this round so please be aware of that just because of the roll calls that are pending out on the House floor and our need to be able to telescope this process in order to make sure that all of the members get a chance to ask questions so none of that came out of your time, Ms. Moler, please begin.

Ms. MOLER. Thank you very much, Mr. Chairman, Mr. Upton and members of the subcommittee. It is, believe it or not, a pleasure to be back. I guess it is like a moth in the flame.

Exelon is an electric and gas public utility holding company headquartered in Chicago. Our subsidiary is Con-Ed in Chicago and PECO Energy in Philadelphia, serve 5.4 million customers or about 12 million people, more than any other company. Our competitive generation affiliate, Exelon Generation, owns, operates or controls about 30,000 megawatts of generation. Our nuclear fleet is the largest in the country and the third largest in the world.

I am testifying today on behalf of Edison Electric Institute. EEI, as you know, is the trade association of U.S. shareholder-owned electric companies. My testimony today details why utilities use over-the-counter derivatives products, examines the costs to consumers of duplicative regulation of OTC derivatives transactions and encourages the subcommittee to support amendments to H.R. 3795 to clarify that FERC has and should remain exclusive, should retain, excuse me, exclusive jurisdiction over organized electricity markets and transactions.

We look at H.R. 3795 from the perspective of our customers who are electric and natural gas consumers. We support the goal of regulatory reform but do not support the current version of the bill. It would result in costly, duplicative and overlapping regulation over organized energy markets and higher costs for our customers. In our view, subjecting OTC transactions to additional regulations, two regulators is simply not warranted because they do not involve or cause the type of systemic risk that the legislation is theoretically designed to deal with.

EEI, EPSA, American Gas Association and 69 other organizations have sent a letter to the members articulating what we believe would be an effective approach to regulating OTC products. In short, the energy industry is united in our belief that this legislation should recognize the clear authority of FERC or the Public Utility Commission of Texas in the case of ERCOT and exempt all Regional Transmission Organizations or Independent System Operators, products and services from regulation by the CFTC. Why? It is simple. Subjecting these types of transactions to additional layers of regulation would be a duplication of effort, impose potential conflicts and gender additional litigation where you have two agencies looking at the same types of transactions and both of them trying to assert jurisdiction over them, and most importantly cost our customers billions of dollars in higher rates.

Your invitation asked me to focus on organized energy markets, the RTOs. Over 65 percent of Americans, 134 million customers live in regions served by RTOs and ISOs. It is not a trivial problem. These independent entities operate the electric road and operate markets. We need to make sure that FERC retains effective authority to regulate RTOs and ISOs.

I do not believe that the legislation is clear on this subject. It gives under the Commodities Exchange Act where the CFTC has authority over things they maintain, "exclusive authority." I don't see how you can have two exclusive bosses in this area. Nor, I might add, do I believe that it can be dealt with by a Memorandum of Understanding between the two agencies because if CFTC has the exclusive authority over these types of transactions, that would at least arguably trump the FERC's jurisdiction. I think that can only be sorted out by statute.

We believe that these transactions such as FTRs, swaps, excuse me, and other types of transactions that routinely entered into as part of RTOs are important consumer protection mechanisms. They reduce electricity costs to our customers and the authority of the FERC to regulate them should not be in doubt. We believe that any proposed legislation should clarify that FERC is the sole regulatory authority governing the organized RTO or ISO markets and the transactions entered therein.

I appreciate very much your offer to have me testify today and would be happy to try to answer any questions.

[The prepared statement of Ms. Moler follows:]

Testimony of Elizabeth A. Moler
Executive Vice President, Government Affairs and Public Policy
Exelon Corporation
On Behalf of the Edison Electric Institute

Before the Committee on Energy and Commerce
Subcommittee on Energy and Environment
United States House of Representatives

December 2, 2009

Mr. Chairman and Members of the Subcommittee:

My name is Elizabeth ("Betsy") Moler, and I am Executive Vice President Government Affairs and Public Policy for Exelon Corporation. I appreciate the opportunity to appear before you today to testify about the impact of H.R. 3795, the Over-the-Counter Derivatives Markets Act of 2009, on organized energy markets.

Exelon is a public utility holding company headquartered in Chicago. Our local retail distribution utilities, Commonwealth Edison (ComEd), which serves northern Illinois and the City of Chicago, and PECO Energy, which serves southeastern Pennsylvania and the City of Philadelphia, together serve 5.4 million customers, or about 12 million people – more than any other utility company in the United States. Our competitive generation affiliate, Exelon Generation, owns and operates or controls over 30,000 megawatts of fossil, hydro, nuclear, and renewable generation facilities. Our nuclear fleet is the largest in the nation and the third largest in the world.

At Exelon, I head our company's Washington, D.C. office and serve as a member of Exelon's Executive Committee. I am responsible for all aspects of Exelon's federal government and regulatory affairs initiatives. I also serve as a member of the Commodity Futures Trading Commission's (CFTC) Energy and Environmental Markets Advisory Committee (EEMAC). Before joining Exelon, I spent 20 years on the Hill, served at the Federal Energy Regulatory Commission (FERC) for nearly 9 years under three Presidents as a Member and as the Chair, and as Deputy Secretary of Energy. I hope that my background as a public servant, and now as a utility executive, means that I have some insights that will be of interest to the Subcommittee.

I am testifying today on behalf of the Edison Electric Institute (EEI). EEI is the trade association of U.S. shareholder-owned electric companies, with international affiliates and industry associate members worldwide. The U.S. members of EEI serve 95 percent of the ultimate electricity customers in the shareholder-owned segment of the industry and represent about 70 percent of the total U.S. electric power industry. My examples and context are from Exelon's perspective but are representative of EEI members' concerns and requests.

My testimony today:

- Enumerates five points that a broad coalition of electric and natural gas companies believe should be included in any over-the-counter (OTC) derivatives reform legislation;

- Requests the Subcommittee to support amendments to H.R. 3795 to clearly establish FERC's plenary and exclusive jurisdiction over organized electricity markets and transactions; and

- Supports expanding the CFTC's jurisdiction to the new proposed markets for greenhouse gas allowances, including the OTC market.

EEI supports the goals of the Administration and Congress to improve transparency and stability in OTC derivatives markets. However, when crafting legislation for that purpose, it is essential that policymakers preserve the ability of electric and natural gas companies to use OTC energy derivatives products and markets for legitimate, important, and prudent business purposes. A large group of end-users has communicated this message to Congress on numerous occasions.[1] Utilities rely on these products and markets to manage wholesale electricity and natural gas price risk thereby helping keep rates stable and affordable for retail consumers.

When considering any increased regulation and requirements of OTC derivatives markets, it is important to note that end user commodity derivatives transactions do not involve or cause the type of systemic risk that Congress is seeking to eliminate through the proposed legislation. In fact, from a quantitative perspective, the entire commodities market is less than one percent of the global OTC derivatives market, and the energy commodity portion is only a fraction of that small percentage. Therefore, we believe that Congress should strike the proper balance in its regulatory reform efforts by establishing energy market oversight rules that allow for prudent use of OTC market-based risk management tools while also providing regulators with the tools needed to protect consumers against market manipulation and systemic risk.

In developing OTC derivatives reform legislation, EEI's membership and 69 other organizations[2] believe that effective legislation should accomplish the following:

- Provide a clear statutory exemption for end-users of OTC derivatives products, such as electric and gas utilities that use OTC derivatives markets to hedge against commodity price risk for natural gas and wholesale electric power;

- Promote clearing of standardized derivatives between large financial dealers, where appropriate, through regulated central counterparties to reduce systemic

[1] *See* October 20, 2009 letter to Members of the U.S. House of Representatives from the Coalition for Derivatives End-Users.
[2] *See* November 20, 2009 letter to Senators Dodd, Lincoln, Shelby and Chambliss from EEI, EPSA, AGA, and other supporting organizations (attached).

risk and bring additional transparency through information sharing regarding pricing, volume and risk. However, we oppose mandates that would require all or most OTC derivatives transactions to be centrally cleared or executed on exchanges;

- Promote greater regulatory oversight and transparency of OTC derivatives through increased transaction reporting and authority to the CFTC to prevent manipulation of the derivatives markets;

- Promote the harmonization and clear delineation of regulatory authority and functions among the Securities and Exchange Commission (SEC), CFTC, FERC, and other Federal agencies to ensure similar products are governed by similar standards. In particular, all regional transmission organization (RTO) or independent system operator (ISO) products and services provided under FERC-approved tariffs and oversight (or Electric Reliability Council of Texas (ERCOT) tariffs approved by the Public Utility Commission of Texas (PUCT)) should be exempt from regulation by the CFTC; and

- Amend the proposed definition of a swap to ensure that financially settled physical transactions are excluded from the definition of swap.

As an electric and natural gas utility, we at Exelon look at the impact of the pending legislation from the perspective of our customers, who are electric and natural gas consumers. We certainly support the goal of regulatory reform, but do not support the current version of H.R. 3795, the Over-the-Counter Derivatives Markets Act of 2009, because it would result in costly, duplicative and overlapping regulation over our sector. The balance of my testimony focuses on that problem.

I will briefly describe and explain: (i) why utilities use OTC derivatives products; (ii) the cost to consumers of unnecessary over-regulation of OTC derivatives transactions; and (iii) why FERC has and should retain exclusive jurisdiction over organized electricity markets.

To understand the role of OTC derivatives, I will begin with a short explanation of how organized electricity markets are currently structured and regulated. I have personal knowledge about these markets, both as a former regulator and as a utility executive. Most of Exelon's generation assets and utilities operate within RTOs or ISOs. In fact, over 65% of Americans, or 134 million customers, live in regions served by RTOs and ISOs. These organizations operate the electric grid in their areas and independently administer transmission assets to ensure access to transmission on a non-discriminatory basis. RTOs and ISOs are subject to extensive oversight and also have independent market monitors who certify that these markets are operated fairly and without unmitigated market power. All RTOs and ISOs and the transactions that occur in them currently are regulated exclusively by FERC (except ERCOT, which is regulated by the PUCT).

OTC derivatives transactions are an integral part of how Exelon manages its exposure to price volatility in the electricity markets overseen by FERC and the PUCT. We use OTC derivatives to reduce the price risk which ComEd, PECO, and Exelon Generation face. Our primary objective as a competitive generation company is to manage the revenue risk we would face due to fluctuations in short-term, spot market power prices. This benefits not only Exelon Generation, but also the retail customers served by ComEd and PECO and other local distribution companies (LDCs) to which we sell power. Exelon Generation also hedges some of its input costs (for example, the cost of coal, oil, natural gas, and uranium).

End-use customers benefit from this hedging because it gives their retail providers greater certainty with respect to costs. LDCs and competitive retail electricity providers can offer consumers longer-term contracts locking in prices because they have reduced their risk by hedging their biggest costs. It is our experience that retail customers in particular want prices for power to be stable rather than subject to the fluctuations of the spot market. Without hedging and trading, utilities simply would not be able to ensure stable retail pricing.

H.R. 3795 would make these types of transactions subject to the CFTC's exclusive jurisdiction and apparently would require them to be cleared and/or traded on exchanges. The requirement to clear and/or trade such transactions on an exchange would definitely increase both wholesale and retail electricity prices. Transactions conducted on an exchange are subject to substantial margin requirements; off-exchange transactions do not have the same margin requirements. Thus parties to off-exchange transactions pay less overhead. According to Exelon's analysis, it is very possible a requirement that virtually all trading activity occur on organized exchanges, either through clearing or futures contracts, could increase the power prices we charge utilities and other customers we serve by anywhere from 5 to 15 percent. EEI President Tom Kuhn has stated that the increased costs of making such trades on exchanges would be "astronomical – in the neighborhood of hundreds of millions of dollars annually for an average utility."[3]

Therefore, if H.R. 3795 were enacted as currently drafted, an additional and unnecessary layer of cost would be added to the marketplace. As currently drafted, H.R. 3795 includes a number of terms that are vague or ambiguous that will need to be clarified prior to passage. The bill is intended to focus on the large financial players whose transactions can pose systemic risk. As currently drafted, it is not clear whether utility end-users are intended to also be covered and subject to the various new requirements. Something this important and costly needs to be clear and should unambiguously exempt end users managing commercial risk from the clearing and exchange-trading requirements. Unless the bill's terms are made more precise, determining which parties and transactions are subject to the bill's clearing requirement will be left to the broad discretion of the CFTC. CFTC Chairman Gensler has stated his position that virtually all OTC transactions should be cleared or traded on exchanges regardless of the cost; we respectfully disagree.

[3] See *For Utilities, Derivatives is not a Dirty Word*, Energy Daily, October 7, 2009.

In addition, any proposed legislation should clarify that FERC is the sole regulatory authority governing the organized RTO or ISO markets and the transactions entered therein. We believe that the Federal Power Act (FPA) affords FERC plenary and exclusive jurisdiction over the organized energy markets and transactions, including financial transactions that settle through RTO and ISO systems, both within and between organizations subject to their regulation. Financially-settled transactions are integrally related to the RTO structure and its primary purpose, which is to ensure the efficient and reliable physical generation, transmission, and wholesale delivery of electricity. FERC already understands the details of these unique transactions, while the CFTC has virtually no experience with them. RTOs and ISOs largely evolved from voluntary regional power pools; FERC has 15 years of experience regulating them. They are creatures of FERC's jurisdiction under the FPA and its progeny, including the Energy Policy Act of 2005 (EPAct 2005). EPAct 2005, which originated in this Subcommittee, already provides FERC strong reliability and market manipulation oversight authority.

Because organized energy markets are already pervasively regulated by FERC, we see no reason for duplicative CFTC or SEC regulation in this space. Gamesmanship, abuse and market manipulation all thrive under this kind of overlapping and confusing regulation. Clear and unambiguous authority for FERC to regulate these transactions is essential. There has already been litigation over which agency has authority over wholesale natural gas transactions and natural gas futures contracts and we cannot afford further confusion. In the end, as we all know, it is the consumer who will pay the price.

We encourage the members of the Subcommittee to support amendments to H.R. 3795 that: (1) clarify FERC's plenary and exclusive jurisdiction over RTO and ISO markets and integrally-related financial transactions, and (2) confirm that RTO and ISO markets, and ERCOT, would not be subject to CFTC regulation as if they were NYMEX-like futures exchanges.

While we do not believe that the CFTC should regulate markets already governed by FERC regulation, we do recognize that the CFTC should play an important role in the emerging greenhouse gas markets, where its expertise will provide benefits. The future greenhouse gas market is distinct from energy markets and any proposed legislation should clarify how these new markets will be regulated. In this space, the CFTC has commodities trading expertise that FERC lacks. Generation-owning entities like Exelon, as well as other emitters, will need to procure allowances to comply with greenhouse gas emission caps as we (and other generators) will own covered entities. In this regime, the cost of allowances will be a cost of doing business for generators. It will be just like the cost of gas, oil, coal or uranium – an input that is necessary to enable us to make and sell our product – and Exelon will need to hedge the price risk associated with that product. Exelon will want to have the wide range of options it currently utilizes to hedge its fuel price and power price risks, meaning the full array of both exchange-traded and OTC offerings that now exist. We recognize, however, that in this new market, as in others, there is a need for fair and balanced regulation. No one wants another crisis that could pose systemic risk, or a market structure with continuing regulatory gaps that can tempt unscrupulous traders to manipulate markets and force prices above or below appropriate market levels.

That is why we support the expansion of the CFTC's jurisdiction to the new market for greenhouse gas allowances, including the OTC market that will certainly develop. This, coupled with a price collar for greenhouse gas allowances, which EEI and Exelon support, should allay any concern that speculators could artificially drive up the price of both the derivatives used to hedge the cost of carbon allowances in OTC markets, and the price of the allowances as such. The Commodity Exchange Act already contains strong anti-manipulation provisions that should be made applicable to these OTC markets, and perhaps revised and refined to ensure that they provide the CFTC the tools it needs to police and prevent manipulation in the new greenhouse gas trading markets.

However, in terms of energy markets that are already regulated by FERC, we believe that for the aforementioned reasons, Congress should recognize and preserve FERC's exclusive jurisdiction. Electric and gas utilities engage in risk management transactions in the OTC derivatives markets to help ensure stable and affordable rates for our customers by helping to hedge against price volatility in natural gas and wholesale electric power – two of the most volatile commodities – and already are substantially regulated. Adding CFTC regulation and costly new requirements to this mix will not resolve the issues that Congress wants to address in the wake of the financial crisis, but will serve only to increase energy costs that will ultimately be passed on to our customers. CFTC regulation should be left to areas where their expertise carries benefits, as would be the case in the market for greenhouse gas allowances.

I appreciate the Committee's invitation to testify today and your willingness to examine these issues. I hope that I have provided you with a sense of the impact of duplicative regulation of energy transactions and how it would result in higher costs for companies like Exelon, which in turn would result in higher costs for our customers. I would be pleased to answer any questions you may have.

EDISON ELECTRIC INSTITUTE

epsa Electric Power Supply Association

AGA American Gas Association

November 20, 2009

The Honorable Christopher J. Dodd
Chairman
Banking, Housing & Urban Affairs Committee
534 Senate Dirksen Office Building
Washington, DC 20510

The Honorable Richard C. Shelby
Ranking Member
Banking, Housing & Urban Affairs Committee
534 Senate Dirksen Office Building
Washington, DC 20510

The Honorable Blanche L. Lincoln
Chairman
Agriculture, Nutrition and Forestry Committee
328-A Senate Russell Office Building
Washington, DC 20510

The Honorable Saxby Chambliss
Ranking Member
Agriculture, Nutrition and Forestry Committee
328-A Senate Russell Office Building
Washington, DC 20510

The Edison Electric Institute (EEI), the Electric Power Supply Association (EPSA), the American Gas Association (AGA) and our undersigned members are writing to express our concern with certain aspects of proposals to address oversight and transparency of over-the-counter (OTC) energy derivatives markets. EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 95 percent of the ultimate consumers in the shareholder-owned segment of the industry, and represent approximately 70 percent of the U.S. electric power industry. EPSA is the national trade association representing competitive power suppliers, including generators and marketers. The competitive power sector operates a diverse portfolio that represents 40 percent of the installed generating capacity in the United States. EPSA members use a variety of fuels and technologies to generate electricity, including coal, geothermal steam, hydropower, natural gas, nuclear, oil, solar, and wind. AGA represents 202 local energy utility companies that deliver natural gas to more than 65 million homes, small businesses and industries throughout the U.S., serving 170 million American in 50 states.

While we support the goals of the Administration and the Congress to improve transparency and stability in OTC derivatives markets, it is essential that policy makers preserve the ability of companies to access critical OTC energy derivatives products and markets. Our members rely on these products and markets to manage price risk and help keep rates stable and affordable for retail consumers.

When discussing any increased regulation of exchange and OTC derivatives markets, it is important to note that these transactions are not the source of systemic risk in the broader economy. In fact, the entire commodity market is less than 1% of the global OTC derivative market, and the energy commodity portion is yet a fraction of that one percent. Therefore, Congress should maintain an appropriate balance between establishing market oversight rules that allow for prudent use of market-based risk management tools and 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.

Our members believe that effective OTC derivatives reform should:

- **Provide a clear exemption for end-users of OTC derivatives products,** such as electric and gas utilities that use OTC derivatives markets to hedge against commodity price risk for natural gas and wholesale electric power. The hedging transactions of derivatives end-users do not contribute to systemic risk, and, therefore, should be exempted from the definitions of swap dealer and major swap participant.

- **Promote clearing of standardized derivatives between large financial dealers**, where appropriate, through regulated central counterparties to reduce systemic risk and bring additional transparency through information regarding pricing, volume and risk. However, **our members are opposed to mandates that would require all or most OTC derivatives transactions to be centrally cleared or executed on exchanges**. The available evidence shows that clearing would **not** bring pricing benefits that would offset the cost of margining for gas and power derivatives, as some have suggested. In fact, the high cash margin requirements of clearing would significantly increase transaction costs for our members and, ultimately, their retail customers. In addition, it would tie up needed cash at a time when the cost of capital is high, access to capital markets is uncertain, and our industry needs to invest billions in renewable energy sources and new energy infrastructure. As a result, our more capital-constrained members may choose to hedge fewer of their transactions, thereby increasing their risks and passing potentially volatile pricing onto retail customers.

- **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. We believe that this transparency can be achieved in a much more cost-effective way through mechanisms such as a central data repository, as opposed to mandatory clearing.

- **Promote the harmonization and clear delineation of regulatory authorities** and functions among the Securities and Exchange Commission (SEC), the CFTC, the Federal Energy Regulatory Commission (FERC) 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. As an example, we believe that **all regional transmission organization (RTO) products and services provided under a FERC-approved tariff and subject to regulatory oversight by the FERC should be exempt from duplicative regulation by the CFTC.**

- **Amend the proposed definition of a swap to ensure that financially-settled physical transactions are excluded from the definition of swap.** Amend the proposed exclusion from the definition of swap that currently reads "a non-financial commodity or security for deferred shipment or delivery, so long as the transaction is

> physically settled" to "a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction contains an enforceable delivery obligation." In order to avoid unnecessary costs (e.g., where a party sits in a chain between the producer and ultimate user of a commodity) and for administrative convenience, many physical transactions are settled through a book-out, which is an agreement between two parties to a forward contract to settle their respective obligations with a cash payment, as opposed to making and taking physical delivery. Book-outs have been exempted under CFTC rules since 1993.

Simply put, electricity and gas utilities engage in risk management transactions in the OTC derivatives markets to help ensure stable and affordable rates for our customers by helping to hedge against price volatility in natural gas and wholesale electric power - two of the most volatile commodities. We stand ready to work with you to craft OTC derivatives reforms that enhance transparency and improve overall market functions without creating adverse unintended consequences and increased costs for us and the consumers we serve.

CC: Members of Senate Committee on Banking, Housing, and Urban Affiars

Members of Senate Committee on Agriculture, Nutrition and Forestry

List of Supporting Organizations:
Allegheny Energy, Inc.
Allete/Minnesota Power
Alliant Energy Corp.
Ameren Corp.
American Electric Power, Inc.
Arizona Public Service Co.
Atlantic City Electric
Atmos Energy
Avista Corp.
Black Hills Corp.
BP America, Inc.
Calpine Corp.
CenterPoint Energy, Inc.
Central Vermont Public Service Corp.
Cleco Corp.
Conectiv Energy
Consolidated Edison, Inc.
Constellation Energy Group, Inc.
CMS Energy Corp.
Delmarva Power & Light Co.
Dominion
DPL Inc.
DTE Energy Co.
Duke Energy Corp.
Dynegy, Inc.
Edison International
Empire District Electric Co.
Energy Future Holdings
Entergy Corp.
Exelon Corp.
FirstEnergy Corp.
FPL Group, Inc.
GDF Suez Energy North America
Great Plains Energy, Inc.
Independent Power Producers of New York
New England Power Generators Association, Inc.
Indianapolis Power & Light Co.
Integrys Energy Group, Inc.
International Power America
LS Power
Madison Gas & Electric Co.
MidAmerican Energy
Mirant Corporation
MDU Resources Group, Inc.
Mt. Carmel Public Utility Co.
National Fuel Gas Co.
National Grid
NorthWestern Energy
NRG Energy, Inc.
NV Energy, Inc.
OGE Energy Corp.
Otter Tail Power Co.
Pacific Gas & Electric Co.
Pepco Holdings, Inc.
Portland General Electric
Progress Energy, Inc.
PPL Corp.
Public Service Enterprise Group, Inc.
Puget Sound Energy
RRI Energy
Sempra Energy
Shell Energy North America
Southern Company
TECO Energy, Inc.
Tenaska, Inc.
US Power Generating Co.
Wisconsin Energy Corp.
Vectren Corp.
Xcel Energy Inc.

Mr. MARKEY. Thank you, Madam Chairman, very much.

Our next witness is Patrick McCullar, President and CEO of Delaware Municipal Electric Corporation. He is today testifying on behalf of the American Public Power Association. We welcome you, sir.

STATEMENT OF PATRICK McCULLAR

Mr. McCULLAR. Thank you very much, Mr. Chairman.

Chairman Markey, Ranking Member Upton and members of the subcommittee, I profoundly appreciate the opportunity to testify before you today.

I am representing the American Public Power Association, as you said. We represent the interests of more than 2,000 publicly owned, not-for-profit electric utility systems across the country serving approximately 45 million Americans, and the majority of our systems are serving communities with populations of 10,000 people or less.

DMEC, my company, provides generation and other services to nine municipal distribution utilities in the State of Delaware and is constituted as both a load-serving entity and a generation owner in the PJM RTO. I have also served as the chairman of the PJM members committee which means I am very familiar with markets and processes within the RTO. I also represent and I often remind my colleagues at PJM that I represent the folks who at the end of the day write the checks to pay for all of these services and our mission is to make sure those checks are as reasonable as possible for the value received.

My statement is going to focus on three areas, energy markets in general, the regulatory overlap between FERC and the CFTC, mandatory clearing of over-the-counter derivative contracts. While energy markets suffer from volatility for many reasons including storage capacity, weather and economics, in recent years the price of energy commodities has not been determined solely by these traditional variables. Manipulation and speculation for profit in energy markets have often caused artificially high prices.

APPA and DMEC have therefore consistently supported increased transparency in these markets to mitigate market manipulation. For example, APPA passed two resolutions the last few years in support of increased transparency in regulation in over-the-counter or OTC natural gas markets, therefore we support the provisions of H.R. 3795 that enhance transparency in these markets including reporting by large traders of OTC positions and the application of aggregates speculative position limits. Because of these strong concerns with market manipulation, APPA and DMEC recognize that the CFTC can help to police and prevent manipulation in the energy markets but CFTC and FERC should work together to prevent manipulation in the energy markets that are run by RTOs, including PJM. However, we urge Congress to avoid creating duplicative authorities between CFTC and FERC over the many other aspects of power supply and transmission markets that are run by the RTOs.

In regions with RTOs, market participants buy and sell a variety of electric products and services in the centralized RTO-run markets. One such market is for the purchase and sale of Financial Transmission Rights or FTRs which APPA members and other

Load Serving Entities use to hedge the cost of transmission congestion created when moving their power from the generation sources to their retail customers which is often referred to as load. While these Financial Transmission Rights are financial contracts, their terms, conditions and rates are comprehensively regulated by FERC and they should remain under FERC jurisdiction. LSE's access to FTRs is absolutely essential to their ability to serve their retail loads at reasonable rates and with less price volatility.

RTO markets are fully regulated by FERC and are set out in FERC-approved tariffs. The rates, terms and conditions applicable to any RTO product under a FERC tariff should not be subject to concurrent jurisdiction by CFTC. Concurrent jurisdiction could result in inconsistent regulations and uncertainty over the enforceability of transactions. Because of this concern, if concurrent jurisdiction is found, CFTC should be required to consult with FERC regarding these markets and should be given statutory authority to cede jurisdiction to FERC. However, as I mentioned, we recognize CFTC has helped to police and prevent manipulation of prices in energy markets. APPA would therefore support concurrent FERC and CFTC jurisdiction over market manipulation in RTO administered markets. APPA would urge the two agencies to pool their resources and expertise to provide more comprehensive oversight in this specific area.

I would also like to mention the critical importance of continuing to allow LSEs and energy end users to use non-cleared, individually negotiated OTC transactions to hedge the price of energy fuels in order to continue to offer the best electric rate possible to our customers. APPA supports the clearing language in H.R. 3795 that provides an exemption from clearing for LSEs and end users. Specifically, requiring not-for-profit public power systems to clear would pose significant financial hardships to them and the local governments that own them without addressing any of the systemic problems that cause the financial crisis in which we now find ourselves. Derivatives end users such as Plug Power Systems do not pose systemic risks to the market as do the bank-to-bank exchanges for the purposes of profit making, therefore, derivative end users should not be subject to the same type of regulation as other entities.

Mr. MARKEY. If you could summarize, sir.

Mr. MCCULLAR. Thank you. Therefore, APPA and DMEC's perspective from our perspective a well-drafted bill will include provisions necessary to curb market manipulation while preserving FERC's primary jurisdiction over RTO markets including the FTR markets in preserving the ability of energy end users to use non-cleared OTC swaps to hedge against energy price volatility. Thank you.

[The prepared statement of Mr. McCullar follows:]

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

Testimony of

PATRICK E. MCCULLAR

PRESIDENT AND CEO OF DELAWARE MUNICIPAL ELECTRIC CORPORATION

ON BEHALF OF

THE AMERICAN PUBLIC POWER ASSOCIATION (APPA)

For the

HOUSE ENERGY AND COMMERCE COMMITTEE'S SUBCOMMITTEE ON ENERGY AND ENVIRONMENT

Hearing on "Impacts of H.R. 3795, the Over-the-Counter Derivatives Market Act of 2009, on Energy Markets"

December 2, 2009

I appreciate the opportunity to provide the following testimony for the House Energy and Commerce Subcommittee on Energy and Environment's hearing on "Impacts of H.R. 3795, the Over-the-Counter Derivatives Markets Act of 2009, on Energy Markets."

I am Patrick McCullar, President and CEO of Delaware Municipal Electric Corporation (DEMEC). DEMEC is a public corporation constituted as a Joint Action Agency and a wholesale electric utility. DEMEC represents nine municipal electric distribution utilities located in the State of Delaware. DEMEC is a Load Serving Entity and a Generation Owner in the PJM Regional Transmission Organization serving 13 states and the District of Columbia. The continued goal and mission of DEMEC is to advance the principles of public power community ownership and provide competitive, reliable energy supply and services to our member's stakeholders and customers. DEMEC is able to accomplish its mission through active representation and participation in regional and federal arenas. DEMEC and its member municipal electric utilities have provided competitive, reliable electric service for decades, and will continue to provide the best service at the lowest possible cost for the ultimate benefit of the consumers and communities we serve.

Today I am testifying on behalf of the American Public Power Association. APPA represents the interests of more than 2,000 publicly-owned electric utility systems across the country, serving approximately 45 million Americans. APPA member utilities include state public power agencies and municipal electric utilities that serve some of the nation's largest cities. However, the vast majority of these publicly-owned electric utilities serve small and medium-sized communities in 49 states, all but Hawaii. In fact, 70 percent of our member systems serve communities with populations of 10,000 people or less.

Overall, public power systems' primary purpose is to provide reliable, efficient service to their local customers at the lowest possible cost, consistent with good environmental stewardship. Like hospitals, public schools, police and fire departments, and publicly-owned water and waste-water utilities, public power systems are locally created governmental institutions that address a basic community need: they operate on a not-for-profit basis to provide an essential public service, reliably and efficiently, at a reasonable price.

Support for Greater Transparency in Energy Markets

Unfortunately, volatility in the price of energy supply such as natural gas and electricity can make it difficult for public power systems to consistently provide electric service to their end-use customers at reasonable prices. While energy markets suffer from volatility for many reasons, including storage capacity, weather and economics, in recent years, the price of energy commodities has not been determined solely by these traditional variables. Manipulation and speculation for profit in energy markets has caused artificially high prices. APPA has therefore consistently supported increased transparency in these markets. In 2007, the APPA Membership passed a resolution in support of increased transparency in over-the-counter (OTC) natural gas markets. Earlier this year APPA members passed another resolution in support of increased transparency and regulation in OTC energy fuels markets.

Regulation of Financial Transmission Rights

Because of these strong concerns with market manipulation, APPA recognizes that the Commodity Futures Trading Commission (CFTC) can play a beneficial role in policing and preventing manipulation in energy markets. The CFTC and the Federal Energy Regulatory Commission (FERC) could be most effective when working together to stop and prevent manipulation in energy markets run by Regional Transmission Organizations (RTOs). However, we also would urge Congress to use caution when drafting legislation, to avoid creating duplicative authorities between CFTC and FERC over all other aspects of power supply and transmission markets that are run by RTOs or Independent System Operators (ISOs).

There are currently six RTOs/ISOs in the country under the jurisdiction of FERC. In regions with operating RTOs/ISOs, market participants buy and sell a variety of electricity products and services in the centralized markets these RTOs/ISOs administer. These power supply-related products and services are typically not furnished by the RTO itself; instead they are sold by market participants through centralized, auction-type market structures that the RTO administers. For example, most RTOs/ISOs operate "day-ahead" and "real-time" markets through which market participants buy and sell wholesale electric power. RTOs also administer markets for the purchase and sale of financial transmission rights (FTRs), which APPA members and other Load Serving Entities (LSEs) use to hedge the costs of transmission congestion associated with the transmission service they purchase from the RTOs/ISOs to move their power supplies to their retail customers (loads).

While these FTRs are financial contracts, their terms, conditions and rates are comprehensively regulated by FERC and they should remain under FERC jurisdiction. These FTRs took the place of the physical transmission rights that LSEs had used to serve their loads prior to the implementation of RTO/ISO power supply markets. The ability of LSEs to have continued access to FTRs on reasonable terms and conditions is absolutely essential to their ability to serve their retail loads at reasonable rates and with less price volatility.

RTO market rules are fully regulated by FERC and are set out in FERC-approved tariffs. The rates, terms and conditions applicable to any RTO product under a FERC tariff should not be subject to concurrent jurisdiction by CFTC. Concurrent jurisdiction could result in inconsistent regulations and uncertainty over enforceability of transactions. Because of this concern, if concurrent jurisdiction is found, CFTC should be required to consult with FERC regarding these markets and should be given statutory authority to cede jurisdiction to FERC.

However, as previously mentioned, APPA recognizes that CFTC has played a beneficial role in policing and preventing manipulation of prices in energy markets. APPA would therefore support concurrent FERC and CFTC jurisdiction over market manipulation in RTO-administered markets. APPA would urge the two agencies to pool their resources and expertise to provide more comprehensive oversight in this specific area.

Mandatory Clearing

Because of the volatility of energy markets, many public power systems use OTC derivatives to hedge the prices of natural gas and electricity that they obtain to serve their end-use customers. Because of their high credit ratings, ensured ratepayer revenue and substantial investment in utility infrastructure, many public power systems do not currently have to pledge liquid collateral for transactions below certain agreed upon dollar levels.

Some proposed legislation would require all OTC derivatives transactions to be cleared. This would require many public power systems to start posting margin for all of their OTC transactions, and require them to have collateral on hand to meet potential margin calls when required.

Requiring public power systems to comply with such requirements for all of their OTC transactions would be cost-prohibitive and would directly raise the price of electricity to their end-use consumers. Rates would increase because of the direct costs associated with clearing—this would include the cost of the required margin needed for each transaction, the cost of the margin the public power system would need to have on hand at any given time, and the increased borrowing costs incurred should the system still use the market to hedge. If a public power system chose not to continue using the OTC market to hedge its transactions because of the costs associated with these requirements, prices would still increase for consumers. This is because the public power system would be exposed to increased price volatility in electricity and natural gas markets, and, as non-profit entities, would have to pass unhedged price increases through to end-use consumers in its retail rates.

Some proposals would allow entities to meet clearing requirements using non-cash collateral. This option, however, generally is not viable for public power utilities. Many of these systems are prohibited by their constitutional documents and/or bond covenants from pledging their assets in such a manner. They would therefore be required to pledge non-cash collateral in the form of liquid assets. Public power utilities do not maintain the kind of liquid assets that would be required to support a transactional requirement.

But more important, mandatory clearing would effectively eliminate the current practice by some public power entities of using tax-exempt financing for the prepayment of long-term natural gas and electricity supply contracts, also known as "prepays." The Energy Policy Act of 2005 endorsed pre-pays by making some clarifications and creating a safe-haven for users of pre-pays should they have unforeseen circumstances such as the loss of a large customer. Since that time, pre-pays have been an extremely important financing tool for public power systems. These contracts allow public power systems to firm up natural gas and electric power supplies for up to 30 years into the future. One critical component of such prepay agreements is an OTC swap transaction that allows the public power system to pay a discounted rate below the prevailing spot market price for the commodity. The OTC derivatives used in prepays are "tear up" agreements; that is, they terminate at no cost in the event the prepay terminates. Due to the size and very long-term nature of a prepay, requiring clearing of a prepay swap would be so cost prohibitive that public power systems would no longer be able to use this important tool. This would increase the exposure of retail customers served by such public power systems to price volatility and, consequently, higher end-use customer costs.

APPA supports the clearing language in H.R. 3795 that provides an exemption from clearing for end-users. APPA opposes legislation that requires all OTC derivatives to be cleared, regardless of the nature of the end-user counter-party. Requiring public power systems to clear would pose significant financial hardships to them and the local governments that own them, without addressing any of the systemic problems that caused the financial crisis in which we now find ourselves. Derivatives end-users such as public power systems do not pose systemic risk to the market, as do bank-to-bank exchanges for the purposes of profit-making. Therefore, derivatives end-users should not be subject to the same type of regulation.

FTRs and buy/sell swaps offer effective risk hedging tools for the Delaware utilities because they face significant transmission cost risks related to insufficient transmission capacity and transmission congestion in the PJM footprint. The Delaware utilities must use these hedging tools to minimize the risk of unexpected price increases in the competitive energy markets and to assure reasonable prices to our end-use consumers. Without these hedging tools, Delaware public power utilities would be exposed to additional costs of as much as 5% of total delivery costs, or $5 million annually.

Continuing to allow energy end-users such as public power systems to use non-cleared, individually negotiated OTC transactions will be extremely important to our members in order to continue to offer the best electric rates possible to their customers.

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In conclusion, while APPA fully supports legislation to curb manipulation in the OTC derivatives market, we urge Congress to use caution when drafting legislation in this area to ensure it does not have an unintended, adverse effect on retail electric and natural gas customers. From APPA's perspective, a well drafted bill will include the provisions necessary to curb market manipulation while preserving FERC's primary jurisdiction over RTO/ISO markets, including the FTR markets, and preserving the ability of energy end-users to use non-cleared OTC swaps to hedge against energy price volatility.

Mr. MARKEY. Thank you very much. We appreciate it.

Our next witness is an old friend and the year is winding down and it is great to have another visit from Glenn English, our former colleague in the Congress and the CEO of the National Rural Electric Cooperative Association. He served 10 terms in Congress representing the great State of Oklahoma and is a great friend of our committee, and he spent the whole year tutoring us on how rural America interacts with all of the major energy issues in our country and we thank you for that, and whenever you feel comfortable, please begin.

STATEMENT OF GLENN ENGLISH

Mr. ENGLISH. Thank you very much, Mr. Chairman, and being very mindful of vote pressures that you are under, the committee is under I will move right along.

I would ask that my entire written testimony be made a part of the record.

Mr. MARKEY. Without objection, so ordered.

Mr. ENGLISH. And also as the chairman pointed out, electric cooperatives, of course, are very important to rural America. I am the CEO of the National Rural Electric Cooperative Association. We have 47 States in which we have some 930 co-ops, 42 million consumers. We are not for-profit and consumer-owned, and we are very proud of that so as you can imagine has been the case all this year, Mr. Chairman, our focus has been on the issue of affordability, and once again, I come to talk to you about the issue of affordability.

First of all, I would like to commend Chairman Peterson for the work that he has done, certainly increasing transparency and reduces systemic risk for end users. I think it is extremely commendable. I think the legislation goes far in achieving these objectives, however the subject of this hearing focuses on a very narrow area and it is one that we have great concern over and I know that this committee does, and I want to commend you, Mr. Chairman, for having this hearing and calling attention to this issues.

We have what I think many of us are very familiar with in which you have two Federal agencies here that could potentially have jurisdiction over an area that is very sensitive, and I would point out to the committee and I think most members of the committee are very aware of the fact that certainly this is a very volatile, sensitive area when you talk about movement of power in this country. And it is extremely important, as this committee has discussed many times that that power move freely, and that it move in a timely fashion, and it move in an affordable way. And in this particular area, I know of no problems that have occurred with regard to the Federal Energy Regulatory Commission in helping bring that about. I am not familiar with any market manipulation issues that have arisen since 2005, and the legislation passed by this committee, and certainly I think that we all are very mindful that it is in all of our best interests, whether we be for-profit or consumer-owned as part of the electric utility industry that we continue to make certain that the power in this country moves in an efficient manner. That is important to consumers and it is certainly important to keep the lights on throughout this nation.

So we have become very concerned, Mr. Chairman, in that we have some questions that have arisen here of exactly how we are going to proceed, and this is something that troubles us a great deal. We would strongly suggest, Mr. Chairman, that as we talk about these transactions, both before the transaction takes place and during the period in which the transaction is being carried out that we have one agency that focus on meeting those responsibilities and that be the Federal Energy Regulatory Commission. I would suggest, Mr. Chairman, a very bright line can be painted after the transaction. They should be fair gain for anyone on any wrongdoing, any market manipulation that is detected whether it be the Federal Energy Regulatory Commission or the Commodity Futures Trading Commission Either way we should encourage and hope that they root out any wrongdoing, and they take those steps that are necessary to deal with it but I think it is very important for us to keep in mind, Mr. Chairman, that we need one agency to focus on that very sensitive, critical period of time as to when these transactions are being carried out. And I know the chairman is very sensitive to time in this area as well so I will wind up by simply saying, I hope that you encourage the two Federal agencies to come together, work with us and work with the two committees in Congress into resolving this difficulty so that we don't have any interference taking place in this marketplace.

Thank you, Mr. Chairman.

[The prepared statement of Mr. English follows:]

Testimony of the Honorable Glenn English, CEO
National Rural Electric Cooperatives Association

Before the
United States House Energy and Commerce
Subcommittee on Energy and the Environment

December 2, 2009

Mr. Chairman, it is an honor to appear before this subcommittee. I thank you for this opportunity to share rural electric co-ops' perspective on the potential negative effects of the Over-the-Counter Derivatives Markets Act of 2009 (H.R. 3795) on our electricity and natural gas markets.

I think it is important to note that Agriculture Committee Chairman Collin Peterson (D-MN) has done a good job putting together derivatives legislation that will go a long way toward increasing transparency and reducing systemic risk, while allowing "end-users", like the rural electric co-ops, to continue to hedge commercial business risks in a cost-effective manner. Chairman Peterson has worked diligently to prevent these reforms from being accompanied by unintended negative consequences. In that spirit, I will share with the subcommittee how the critical transactions in our electricity and natural gas markets could be inadvertently jeopardized if certain modifications are not made to this legislation.

As most of you know, the National Rural Electric Cooperative Association (NRECA) is the not-for-profit, national service organization representing nearly 930 not-for-profit, member-owned, rural electric cooperative systems, which serve 42 million customers in 47 states. NRECA estimates that cooperatives own and maintain 2.5 million miles or 42 percent of the nation's electric distribution lines covering three-quarters of the nation's landmass. Cooperatives serve approximately 18 million businesses, homes, farms, schools and other establishments in 2,500 of the nation's 3,141 counties. Cooperatives still average just seven customers per mile of electrical distribution line, by far the lowest density in the industry. These low population densities, the challenge of traversing vast, remote stretches of often rugged topography, and the increasing volatility in the electric marketplace pose a daily challenge to our mission: to provide a stable, reliable supply of affordable power to our members—including your constituents. That challenge is critical when you consider that the average household income in the service territories of most of our member co-ops lags the national average income by over 14%.

Mr. Chairman, we are concerned that the legislation could inadvertently make it difficult and/or much more expensive for an electric generation and transmission co-op to buy power in a Regional Transmission Organization (RTO) market, or even to buy and deliver the energy and capacity they need to serve their own members in RTO regions. RTOs are independent operators of the high voltage electric power grid and are responsible for providing open access transmission service and ensuring the reliability of the transmission systems they operate. Most RTOs also operate real-time and day-ahead markets for electric power. These markets establish locational marginal prices (LMPs) for energy, based on the bid price of the last unit dispatched to meet load in the RTO region.

The level of congestion in different parts of the transmission system can and does change regularly. Therefore, the cost of power consumed in any part of the system can be extremely volatile. That volatility is challenging for utilities because the LMPs not only establish the cost of power for utilities buying energy out of the market at a particular location, the LMPs also establish the cost for utilities with their own power resources to transmit power from those resources on one part of the system to their consumers on another part of the system. Utilities are paid the LMP price for energy they generate at one point of the system and then pay the LMP price for energy at the point where it is withdrawn to serve consumers. Thus, changes in the LMP at either the "source" of the power or the "sink" change the cost of delivered power due to congestion costs incurred in delivery.

In order to help utilities hedge these risks and manage costs, the Federal Energy Regulatory Commission (FERC) requires RTOs that operate real-time and day-ahead LMP markets to make "financial transmission rights" (FTRs) or "congestion revenue rights" (CRRs) available to market participants. FTRs and CRRs are financial instruments that entitle holders to congestion revenues from a particular transmission path. These FTR revenues help offset the costs incurred by utilities to deliver energy over the congested transmission paths.

For example, if a utility that must move power from point A to point B owns the FTR from A to B, then their obligation to pay congestion costs between A and B is offset in part or in whole by their right to recover the congestion revenues over that same path. These FTRs and CRRs are absolutely essential for electric cooperatives and other load serving entities (LSEs) within RTO regions. Without these hedging tools, it would be much more risky and much more costly for LSEs to manage their resource portfolios and deliver power to their consumers. These tools are so important to the efficient and reliable planning and operation of the electric grid that the Energy Policy Act of 2005 directed FERC to ensure that all LSEs have access to the long-term FTRs they need to meet the long-term needs of their electric consumers. LSEs need the long-term certainty offered by long-term FTRs in order to invest in the long-lived, capital-intensive assets such as power plants (50+ year assets) and transmission facilities (30+ year assets) that are needed to provide reliable electric service.

RTOs and the other bilateral contract (the "over-the-counter" or "OTC) markets have also supported investment in generation resources through active capacity markets. RTOs manage auctions and the secondary purchase and sale of "capacity" contracts, which commit the seller to provide a generation resource if the RTO calls on the seller to provide power to the grid in its region. The markets in such capacity products, whether run by the RTOs or the bilateral OTC contract markets, enable electric companies to meet their reliability obligations to the grid operator and encourages infrastructure development. Investors are provided the revenue stream they require to ensure they recover their costs and provide buyers with the certainty that the power they need to serve consumers will be available when they need it. It should also be noted that it is common for electric co-ops to have long-term purchases of capacity rights and physical energy "bundled together" in a single contract at a single price to economically meet its needs for both RTO requirements.

In some ways, these FTR and capacity contracts are the economic equivalent of financial derivatives or "swaps" under the new legislation. Rural electric co-ops are concerned that the proposed legislation could impose duplicative and costly regulation on RTOs and jeopardize contracts for both FTR and capacity markets.

The RTOs created the FTR and RTO-based capacity contracts, and the Federal Energy Regulatory Commission (FERC) comprehensively regulates all jurisdictional wholesale sales and jurisdictional interstate transmission service, pursuant to the Federal Power Act, as an integral part of the overall electric market structure focused on reliability. Sections 205 and 206 of the Federal Power Act give FERC authority to ensure that the rates, terms, and conditions of all jurisdictional wholesale sales of power and all jurisdictional transmission in interstate commerce are just and reasonable. In order to fulfill that duty, FERC has required RTOs to file tariffs at FERC governing every aspect of their markets. The design, operation, and governance of RTOs, the products sold in RTO markets, the mechanisms for setting prices in those markets, the financial rights and obligations of parties who participate in the markets, and the means the RTOs use to monitor the markets for market power and market manipulation are all filed at FERC and subject to FERC review and oversight. The FTRs and RTO capacity markets that are at issue here were created by RTOs at FERC's direction, according to standards established by FERC, and are bought and sold pursuant to FERC-filed tariff. Mismanagement of the markets by the RTOs and misconduct in those markets by participants are both subject to stiff penalties from FERC.

H.R. 3795 purports to give the CFTC "exclusive jurisdiction" over all derivatives, or "swaps" (other than securities-based swaps), without recognizing FERC jurisdiction, much less FERC exclusive jurisdiction, over wholesale electric transactions and transmission in interstate commerce. This bill therefore purports to subject all "swaps" to the provisions of the Commodity Exchange Act or "CEA."[1] The legislation proposed by the Treasury Department, the House Financial Services Committee and the House Agriculture Committee all do this by simply eliminating the swaps exemption from the CEA, and eliminating many of the other exemptions which have allowed the OTC energy derivatives markets, of which the RTO markets are a part, to develop without CFTC jurisdiction.[2] Instead, the bill adds the term "swap" to many of the sections of the CEA, and then defines "swap" broadly in a proposed new provision of Section 1a of the CEA.

The term "swap" is essentially defined as: 1) an option on virtually anything, 2) any transaction dependent upon the occurrence or non-occurrence of a wide variety of events or circumstances or providing for an exchange of payments based on virtually anything, or 3) any transaction that is "commonly known" as a swap. The definition is very broad and could be read to authorize the CFTC to regulate all OTC derivatives transactions in the same way. Although H.R. 3795 includes a list of exclusions from the definition of "swap" and exemptions from other provisions, none of the exclusions or exemptions appear to fit the FERC-regulated RTOs, RTO markets and RTO products.

We are concerned that the CFTC does not have the same regulatory experience with power and transmission markets that FERC possesses. The CFTC does not have the same regulatory priorities – reliability and just and reasonable rates for electricity, and it does not routinely recognize, in its market regulation, the financial issues facing entities like NRECA's members,

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[1] See proposed changes to Section 2(a) and 2(c) of the CEA in Section 102 of H.R. 3795

[2] See Section 103 of the H.R. 3795 that eliminates CEA Sections 2(d), 2(e), 2(g) and 2(h) entirely

who may have lesser financial credit metrics than some financial institutions, but who nonetheless have to participate in the RTO power markets. In recognition of these differences in market participants' financial credit quality, the RTO credit support mechanisms are structured to allow NRECA members to participate without the costly capital and margining rules applicable in other commodity markets. The RTOs, their markets and their products are structured to achieve FERC's and the RTOs' regulatory priorities, and to enable the LSEs to serve their customers and hedge their commercial business risks. Therefore, if the CFTC were the primary regulator of the RTO markets or products, there could be reliability problems caused by a different approach to market structure, and there would almost certainly be significant administrative and margin and credit costs for NRECA members.

NRECA is also seeking clarification in the bill of the "physical transaction" exclusion from the definition of swap. Many physical forward electric and natural gas transactions are entered into with the intent of physical delivery, but are "booked-out" before delivery, for scheduling efficiency. These transactions are already regulated by FERC and subject to extensive record-keeping and reporting requirements and should not be subject to additional or inconsistent regulation. It is important to clarify the "physical transaction" exclusion to the definition of swap so the bill does not unintentionally put such transactions within the domain of CFTC derivatives regulation. If not addressed in the bill, this new regulation could subject physical natural gas or power transactions to duplicative, costly new regulation. Those administrative burdens and costs would be borne by NRECA members.

Mr. Chairman, in short, I believe FERC should keep its exclusive jurisdiction over RTOs. RTO markets and RTO-created products are integral to the RTOs' regulatory reliability mission. FERC should also maintain its jurisdiction over physical forward natural gas and power transactions, whether or not those transactions ultimately result in physical forward delivery or are "booked out," and over bilateral OTC capacity transactions. However, the CFTC should be able to maintain its current market manipulation authority over the bilateral OTC natural gas and power markets. Finally, we request that the two commissions remain disciplined in meeting the harmonization of legislative goals by entering into a memorandum of understanding and reporting back to Congress periodically on the ways in which the CFTC is using its authority to avoid, reduce or eliminate duplicative and inconsistent regulation.

Mr. Chairman, as a former Member of Congress I can tell you that one of the most difficult laws I've ever had to deal with was the "law of unintended consequences". I know you are working to minimize those unintended consequences in this legislation, and I thank you for your attention to this matter.

Mr. MARKEY. Thank you, Mr. Chairman, as well. When did you leave, Glenn?

Mr. ENGLISH. That was 1994, and we did have jurisdiction out of my subcommittee at the Commodity Futures Trading Commission back in those days.

Mr. MARKEY. I remember that yes, long ago.

Mr. ENGLISH. I am afraid so, very long ago. We are both getting older.

Mr. MARKEY. Our next witness is John Shelk. He is the President and CEO of the Electric Power Supply Association. That is the national trade association representing competitive power suppliers, and back when I was the chairman of this subcommittee in 1985 and 86, John was the chief counsel for the ranking member of the committee at the time. We did the Appliance Efficiency Act that year, Carlos the refrigerator warhead and that was when, if you remember, William "the Refrigerator" Perry couldn't get a bigger and better nickname than that. But I don't know if you know this but refrigerators now basically consume 50 percent less electricity for the same size device as they did in 1986, and so Mr. Shelk has—what John?

Mr. SHELK. That is a long time ago.

Mr. MARKEY. It is a long time ago but we welcome you back, John.

STATEMENT OF JOHN SHELK

Mr. SHELK. Thank you, Mr. Chairman, we appreciate the invitation.

As you indicated, EPSA represents competitive wholesale suppliers including generators and marketers who do business both in the two-thirds of the country with organized markets and in the one-third without them. The competitive sector has 40 percent of U.S. generating capacity with an even greater role in the organized markets.

As you kindly mentioned, for 10 years I had the honor of working for members of this committee including on FERC matters, and more recently I have joined the CFTC's Energy and Environment Markets Advisory Committee and fully support the transparency goals Chairman Gensler outlined to you this afternoon, the question is how to do so. Our position is that there is no more important issue to be acted upon by the Congress in the near future that will impact the electric sector than maintaining cost-effective access to OTC risk management products for all the reasons you have heard from the other panelists. We commend the CFTC for listening to our concerns and we also appreciate changes to the original version on H.R. 3795 made by the Committees on Financial Services and Agriculture, however for reasons that you have heard, three crucial details remain.

First, definitions should ensure access to OTC risk management products by those of us primarily managing commercial risks without imposing mandatory clearing due to how it would constrain our capital availability at a time when you rightly expect us to be investing in the energy infrastructure of the future. Second, margin requirements should not apply to those who use OTC products to manage commercial risks for the same reason and for what you have been focusing on this afternoon, we agree that a clear line should be drawn in the statutory language between the important responsibilities Congress assigns to the two agencies. Understandably, for those actually implicated in the financial crisis, the bill as it stands today defines what is within the CFTC's exclusive purview very broadly, however as you have heard this raises very serious questions as to FERC's exclusive regulation of wholesale markets, markets which were not implicated by the financial crisis and we share those concerns.

FERC's exclusive jurisdiction should be preserved by adding a provision to the bill that excludes any products transacted through or in reference to the RTOs and ISOs FERC regulates, and most importantly for my members who serve many of your constituents, these are the markets from which electricity suppliers receive the revenues necessary to operate and invest. As a result, electricity markets are systems that are physically and financially integrated so extensively as this committee is well aware, as to sharply distinguish electricity from the corn and Treasury bill examples you heard earlier, thus dual or coexisting regulation while not impossible, is more problematic, hence the recommendation for a statutory bright line because as you know, all these things are interrelated. Physically you cannot pull them apart like you can corn and T-bills from the different agencies.

For all the reasons you have heard that I won't belabor, RTOs and ISOs are subject to multiple layers of oversight. The extent of this oversight and the documented competitive market results that the organized markets produced to benefit consumers are ample evidence of the effectiveness of FERC's regulation that should be preserved. Unfortunately, the bill as it stands, as I mentioned, does not yet expressly and fully address this important issue. We strongly urge you to do so to preserve FERC's jurisdiction over the organized markets of which a large and growing share of the country depends for its electricity.

And again, we thank you for the invitation and look forward to your questions.

[The prepared statement of Mr. Shelk follows:]

PREPARED STATEMENT OF

JOHN E. SHELK
PRESIDENT AND CEO
ELECTRIC POWER SUPPLY ASSOCIATION

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON ENERGY AND COMMERCE
SUBCOMMITTEE ON ENERGY AND ENVIRONMENT

HEARING ON

"IMPACTS OF H.R. 3795, THE OVER-THE-COUNTER DERIVATIVES MARKETS ACT OF 2009, ON ENERGY MARKETS"

DECEMBER 2, 2009

Chairman Markey, Ranking Member Upton and Members of the Subcommittee:

Thank you for the opportunity to participate in today's hearing on the impacts of H.R. 3795, the Over-the-Counter Derivatives Markets Act of 2009, on energy markets.

The Electric Power Supply Association (EPSA) is the national trade association for competitive wholesale power suppliers, including generators and marketers. EPSA members include both independent power producers and the competitive wholesale generation arms of certain utility holding companies. EPSA members do business nationwide, both in the two-thirds of the country served by Regional Transmission Organizations (RTOs) or Independent System Operators (ISOs) and the remaining one-third of the country dominated by traditional vertically-integrated utilities.

The competitive power sector operates a diverse portfolio that represents 40 percent of the installed generating capacity in the United States. In many regions, such as the Northeast, Mid-Atlantic, portions of the Midwest, Texas and California, the competitive wholesale generation is over half to as much as 100 percent of the area's power supply. EPSA members use a variety of fuels and technologies to generate electricity to reliably serve consumers, including coal, geothermal steam, hydropower, natural gas, nuclear, oil, solar and wind.

EPSA joins other national energy trade associations in commending the Committee on Energy and Commerce for holding this hearing. There is no more important issue likely to be acted upon by Congress in the near future that will impact the ability of the electric power sector to operate existing plants to best serve consumers and to invest in new energy infrastructure than whether our members will continue to have access to the over-the-counter (OTC) derivatives markets on fair and reasonable terms.

As a member of the Commodity Futures Trading Commission's (CFTC) Energy and Environmental Markets Advisory Committee (EEMAC), I am well aware of and support the goals of bringing greater transparency and proper regulation to derivatives markets. EPSA supports the goals of the original Treasury Department proposal released earlier this year in terms of avoiding a repeat of the costly systemic risk posed by trading in credit default swaps and other transactions between purely financial firms.

At the same time, EPSA joins a unanimous energy end-use sector in strenuously advocating that financial regulatory reform, as it relates to derivatives, should not punish us and the consumers we serve for the actions of others who nearly brought down our financial system last year. This would occur through overly broad requirements that would essentially require energy end-user derivatives products, presently transacted on the OTC markets, be handled on an exchange and cleared through a central clearinghouse associated with the exchange.

EPSA commends the CFTC for its willingness to listen to the serious concerns expressed by energy end-users. We also greatly appreciate the changes made by the Committees on Financial Services and Agriculture to the original Treasury Department proposal that required clearing. Both committees' versions of H.R. 3795 include new exceptions to clearing which allow energy end-users engaged in OTC transactions to continue to use such markets to hedge and mitigate their exposure to commodity price fluctuations. Neither version, as reported, forces end-users to clear transactions simply because the counterparty is a large financial institution as was once considered.

However, as explained in more detail below, several critical legislative details remain to be firmly nailed down, including **(1)** definitions of key terms (e.g., major swap participant, swap dealer, swap, and substantial net position) to ensure that energy end-users' access to OTC derivatives are in fact fully protected as intended, **(2)** excluding costly and unnecessary margin requirements from being imposed on energy end-users who utilize OTC markets, and **(3)** as clear a jurisdictional line as possible is drawn between the important responsibilities of the Federal Energy Regulatory Commission (FERC), the Public Utility Commission of Texas, and the CFTC, respectively.

It is important to step back and look at the basics of electricity generation to understand why it is so critically important to the energy and environmental goals of this Committee that Congress get the regulation of OTC derivatives markets set up properly. At the most basic level, all electricity generation companies use various fuels to generate electricity. Depending on the technology, fuel represents the largest variable cost of power generation. In addition to fuel input costs, electricity generators also have to factor in the cost of any necessary emissions credits. On the output side, depending on the company and the power market, revenues from power generation are determined by market-based wholesale prices, power purchase agreement pricing terms, or cost-based rate-setting by states and others for vertically-integrated utilities.

Given the long term nature of power plant investments, and the volatility of both fuel and emissions credit input costs and wholesale power prices that determine revenues, companies engage in a variety of prudent risk management strategies to make these costs and revenues more predictable. By doing so, companies can manage cash flows by locking in some or all of these costs and revenues, which reduces costs and risks for consumers. Among other things, this permits wholesale generators to bid at competitive fixed prices to serve those states with restructured retail electricity markets in which the local electricity distribution company procures power supplies in a competitive auction to serve those consumers who do not elect an alternative retail provider. By stabilizing more predictable cash flows, these risk management practices also assist power generators in obtaining the financing necessary to maintain and expand the nation's energy infrastructure, particularly as the nation moves to de-carbonize the electricity sector.

In general terms, there are at present two types of venues to purchase the necessary risk management products: transactions through exchanges that have central clearinghouses and directly with counterparties through the OTC markets. Both venues are important and access to each is necessary for energy end-users such as power generators to best serve their customers through prudent risk management.

The primary benefit of transacting with an exchange that has a central clearinghouse is that doing so eliminates the credit risk of doing business with a specific counterparty. Instead, the exchange with the clearinghouse becomes the counterparty and guarantees performance. However, this only works well for risk management products with highly standardized terms and conditions for which there is a very liquid market composed of lots of buyers and sellers. Furthermore, the elimination of counterparty risk comes with significant attendant costs, primarily in the form of initial posting of cash collateral and potentially additional cash collateral requirements during the term of the transaction (e.g., initial and variation margin) depending on how the value of the derivative changes and in whose favor over time.

By contrast, energy end-users, such as power generating companies, use the OTC market when in need of more customized risk management products directly with specific counterparties. This customization includes both the underlying risk being hedged (such as fuel input costs or power output prices) and the collateral requirements. As to the risk being hedged, the OTC market is particularly important to power companies given that as a practical matter electricity cannot be stored so it must be generated and consumed simultaneously. Combined with the physical nature of the grid, this means that electricity must be priced and traded at hundreds of points across the country. As to collateral, the OTC market allows the parties to directly negotiate credit arrangements tailored to their circumstances.

The difference between the collateral requirements imposed by exchanges with clearinghouses and the tailored arrangements of the OTC market is at the heart of why we oppose having our risk management options limited to only those products available on exchanges with clearinghouses. The sums of cash that would be taken out of the economy and parked at clearinghouses if end-users are subject to mandatory clearing runs into the tens of billions of dollars for the power generation sector alone. Instead, this capital is needed for investments in energy infrastructure, including addressing reliability and environmental concerns.

By contrast, the OTC market permits a wider variety of collateral arrangements. In some cases, there is no collateral up to limits specifically agreed to by the parties to the transaction. In other cases, the collateral posted by energy end-users takes the form of letters of credit or liens on the power generation assets, not cash. There has been no suggestion – none at all – much less any evidence that these long-standing credit arrangements pose any systemic risk to the U.S. financial system. Accordingly, while requiring exchange trading and clearinghouses may make sense for transactions between financial firms, particularly for non-physical products such as credit default swaps that dwarf the value of energy derivatives, doing so is not appropriate when one of the parties to the transaction is an end-user, such as a power generation company.

We are pleased that at a conceptual level at least there is growing recognition of the importance of maintaining maximum risk management flexibility for all end-users. We are encouraged by statements made by CFTC Chairman Gensler that end-users should be able to continue to post non-cash collateral and that the goal of transparency in the OTC markets is not dependent on clearing. We agree.

In the final analysis, the legislative details of whatever is finally enacted into law matter the most. Accordingly, we make the following recommendations to Congress:

- The desired increased transparency in OTC markets we fully support is best achieved through greater reporting requirements, including a central data repository for all OTC transactions. H.R. 3795 includes such requirements.

- Energy end-users should not be subject to the requirements for central clearing inspired by unrelated abuses by others. H.R. 3795 imposes clearing on "swap dealers" and "major swap participants" making the precise definitions of these terms critical. As noted earlier, the Financial Services and Agriculture Committees made major strides by not adopting the broader clearing requirements in the original Treasury Department proposal.

However, under H.R. 3795, the definitions of "swap dealer" and "major swap participant" are subject to interpretation. We support a brighter line that clearly and unambiguously excludes end-users who primarily use derivatives for hedging, managing or mitigating commercial risk regardless of the counterparty.

- The definition of "swap," to which the clearing requirement would apply, should not include financially-settled physical transactions known as book-outs, consistent with long-standing CFTC treatment of these forward transactions.

- The definition of "swap" should expressly not include the day-ahead, real-time and financial transmission rights products in RTOs and ISOs. These markets are independently administered by the RTOs and ISOs under detailed FERC-approved tariffs (or tariffs approved by the Public Utility Commission of Texas for ERCOT) and subject to multiple layers of oversight including by independent market monitors. FERC should have plenary and exclusive jurisdiction over RTO/ISO products. There has been no showing as to why they should be separately regulated by the CFTC in addition to the existing multiple layers of oversight. At present, H.R. 3795 does not address this key jurisdictional issue. We strongly urge that Congress address it in H.R. 3795.

- Any speculative position limits should be set by the CFTC with a directive to maintain sufficient liquidity for legitimate end-user hedging transactions.

- The determination of which products are accepted for central clearing on an exchange (as opposed to remaining on the OTC market) should be made by federal regulators, not by the exchanges. Some versions of the legislation leave this decision to the clearinghouses that would benefit from finding a product clearable. This issue continues to appear somewhat unsettled in light of discussions following the committee markups of H.R. 3795.

- Margin requirements should not apply to OTC transactions for the same reasons that clearing should not be required. The Financial Services Committee version of H.R. 3795 would permit the CFTC to apply such margin requirements, which would defeat the exclusion from mandatory clearing. The Agriculture Committee version wisely does not include such a provision.

- The changes made by the new law should be prospective and clearly not apply to any derivatives transactions entered into prior to enactment.

Thank you for the opportunity to present these views and recommendations on these important issues, on behalf of competitive electricity suppliers and our customers. We look forward to working with all relevant Congressional committees, along with federal regulatory agencies, to strike the proper balance between greater financial transparency and maintaining access to necessary energy risk management products on fair and reasonable terms. Doing so will allow us to best serve our customers while investing tens of billions of dollars in new, cleaner energy infrastructure.

Mr. MARKEY. Thank you, Mr. Shelk, very much.

Our final witness is Vincent Duane, General Counsel for PJM, that is Pennsylvania, Jersey and Maryland.

Mr. DUANE. Originally, that is correct.

Mr. MARKEY. Right, the regional transmission organization that serves much of the mid-Atlantic and parts of the Midwestern region of the country. So what other States are in now?

Mr. DUANE. We are, Chairman, in 14 States if you include the District of Columbia, 13 States and the District of Columbia, as far out west as Illinois up to the New Jersey-New York border down into North Carolina and a good part of the country in between.

Mr. MARKEY. And they wouldn't want to be run by a group called Pennsylvania, Jersey and Maryland so the name change is to protect, you know, the innocence.

Mr. DUANE. Hence, my reluctance in agreeing with you on the original, historical derivation.

Mr. MARKEY. I see, yes. You probably made a consultant $100,000 to make that recommendation so you joined PJM in 2003 as deputy general counsel and has served as general counsel since 2007. Have you ever been before this committee before?

Mr. DUANE. This is my first time, sir.

Mr. MARKEY. First time so we have a brand new witness. Welcome to our committee and, you know, it is just great to have some new faces coming before us so whenever you feel ready, please begin.

STATEMENT OF VINCENT DUANE

Mr. DUANE. Well again, thank you, Mr. Chairman, Ranking Member Upton and the rest of the committee members for the invitation to be here today.

I am testifying on behalf of PJM and I would request that the written testimony be included as part of the record.

Mr. MARKEY. Without objection, it will be so ordered.

Mr. DUANE. Thank you very much.

We are as has been mentioned a RTO, Regional Transmission Organization, and a public utility. That means we are regulated by the FERC. We perform several functions and the one that is of most interest today is our function in administering organized wholesale electricity markets. We administer these markets for two reasons.

First, we want to bring competitive forces to the transacting of wholesale purchases in the electricity markets and we use them and this is very important as a tool to help us discharge our responsibility in managing the grid reliably. It is a tool that incents people, be they generators, transmission customers and increasingly consumers and load interests in responding to prices that result in behavior that keeps the grid reliable and basically helps us in our mission in keeping the lights on. But the markets are the focus today and with particular attention being given to the FTR product that we administer in PJM. This product has caught the attention of the CFTC. I believe it is part of its overall interest as Chairman Gensler mentioned in bringing oversight to the over-the-counter markets.

My first point, and probably the most important point I want to make is that the public policy and they are very important public policy imperatives that are driving financial market reform are simply not present when it comes to the RTO markets. Its not that we don't share in the objectives that Chairman Gensler mentioned, lowering risk, promoting transparency and bringing integrity to the public. Absolutely do we endorse those risks, in fact, we feel we put those at the very front of our windshield. We just get them to them and we get to those objectives in a slightly different way.

We are not an OTC environment. We are a centralized marketplace and one that is pervasively, some would say intrusively regulated by the FERC. Our markets are not opaque. It is hard to think of a more transparent environment than an RTO. Let us look at the FTR with particular reference here. When an FTR is bought and sold, the name of the holder of the FTR is publicly available. The price they pay for that FTR is publicly available and the identity of the particular FTR pathway is publicly available. It is all available to market participants in the FTR markets on the PJM Web site and there is no transparency issue. We get to that through the centralized markets regulated by the FERC and the products are not synthetic financial products. Admittedly they do settle financially but they are very closely tied to the physical capability of the transmission system and they are essential to our mission of delivering firm transmission to customers and ensuring that those customers have some degree of price certainty in moving their electricity from point A and point B, and these are missions that this committee and the Congress has squarely entrusted to the FERC.

The second point I would like to make is we are not and we are quite distinct from the sort of financial institutions that operate in the OTC markets. We are a non-profit entity. We don't make money on FTRs and we don't have structuring desk that is populated by Ph.D. mathematicians devising exotic instruments, packaging them and marketing them to other financial institutions. That is not what an FTR is all about. In fact, we have another function that I mention in my testimony where we are a transmission planner and we look at opportunities to expand the transmission system to remove congestion to increase transfer capability which is to say the ability to move electricity from one point to another and in doing so reduce the reliance on FTRs. So we are quite distinct from a financial institution that might be trying to market a product. We are in a sense, trying to eliminate the need for or at least lessen the reliance on the FTR product.

The last point I would like to make is to sort of answer the question I think is at the heart of this which is well what is so wrong with having a dual role with the CFTC and the FERC, and why is this a matter that needs some statutory attention, and it is not just a desirability to bring clarity. It is not just to eliminate duplication and dare I say it is not just to avoid costs. It is really a question that the tools that the CFTC uses just have not been a very good fit for the products and markets and environments that we operate. We get to those objectives through different mechanisms and don't see the same need to get to the risks that have been identified.

I would like to close on that point and make myself available for questions.

[The prepared statement of Mr. Duane follows:]

United States House of Representatives

Committee on Energy and Commerce

Subcommittee on Energy and Environment

Executive Summary of Testimony of Vincent P. Duane,

Vice President & General Counsel, PJM Interconnection L.L.C.

"Impacts of H.R. 3795, the Over-The-Counter Derivatives Markets

Act of 2009, on Energy Markets"

December 2, 2009

In the attached testimony, Vincent Duane, Vice President and General Counsel for PJM Interconnection, L.L.C. ("PJM"), details the potential conflicts and harm to customers should certain provisions of H.R. 3795 or the existing Commodity Exchange Act be interpreted to apply to FERC-regulated Regional Transmission Organization ("RTO") markets. PJM is a FERC-regulated RTO responsible for ensuring the reliable and non-discriminatory planning and operation of the transmission grid and the fair and efficient administration of wholesale electric markets. PJM serves 51 million people in an area that includes all or parts of New Jersey, Pennsylvania, Delaware, Maryland, the District of Columbia, Virginia, North Carolina, West Virginia, Kentucky, Ohio, Michigan, Indiana, Illinois and Tennessee - an area representing approximately 19 percent of the nation's Gross Domestic Product.

Mr. Duane's testimony details the Federal Energy Regulatory Commission's long history of regulation of these markets and the Energy and Commerce Committee's own historic exercise of jurisdiction and oversight over these markets. His testimony outlines the potential adverse impact on wholesale electricity customers if financial transmission rights are deemed to fall within CFTC's exclusive jurisdiction including the potential for less oversight than presently exists and the addition of unnecessary requirements that could impact the availability of financial transmission rights to smaller utilities who need these rights in order to cost effectively meet their service obligations to their customers.

United States House of Representatives
Committee on Energy and Commerce
Subcommittee on Energy and Environment

Testimony of Vincent P. Duane, Vice President & General Counsel
PJM Interconnection, L.L.C.
"Impacts of H.R. 3795, the Over-The-Counter Derivatives Markets Act of 2009, on Energy Markets"
December 2, 2009

My name is Vincent Duane and I serve as the Vice President and General Counsel for PJM Interconnection, L.L.C. ("PJM"). PJM is a FERC-regulated Regional Transmission Organization ("RTO") responsible for ensuring the reliable and non-discriminatory planning and operation of the transmission grid and the fair and efficient administration of wholesale electric markets. PJM serves 51 million people in an area that includes all or parts of New Jersey, Pennsylvania, Delaware, Maryland, the District of Columbia, Virginia, North Carolina, West Virginia, Kentucky, Ohio, Michigan, Indiana, Illinois and Tennessee – an area representing approximately 19 percent of the nation's Gross Domestic Product.

Thank you Chairman Markey and the Subcommittee on Energy and Environment for inviting PJM to address this important subject. We recognize this Subcommittee's key role in analyzing the impact of efforts to adopt regulatory reform of our nation's financial markets.

Our country's financial markets are both varied and complex. And while the innovation and evolving sophistication of our financial institutions should be encouraged generally in order to manage risk, spur investment and realize efficiencies, the need for increased supervision over the trading of certain products in certain environments can no longer be doubted. Today's hearing signals a helpful reminder to Congress: "let's keep our eye on the ball".

Consider those products related to the purchase, sale and transmission of electricity which are undertaken in fully transparent environments administered by the nation's Regional Transmission Organizations ("RTOs") and Independent System Operators ("ISOs"). The transacting of these products in these environments should *not* be seen as warranting either a new regulator or a new regulatory construct. This is so, quite simply because the RTO/ISO products and their environments are *already* subject to comprehensive and proactive regulation by the Federal Energy Regulatory Commission ("FERC").

With Congress' help, much important work needs to be done by the Commodity Futures Trading Commission ("CFTC") to increase oversight and control and restore to a sounder footing the trading of certain financial products, such as swaps, in certain environments such as over-the-counter platforms. But to direct the CFTC through the Over the Counter Derivates Markets Act of 2009 (H.R. 3795) or enable the CFTC, under an expansive interpretation of the existing Commodity Exchange Act, to assert regulatory jurisdiction in an area already fully occupied by the FERC is wasteful and an unwelcome distraction from the important job of the day: reforming the oversight of those products and trading environments that are unduly opaque and presently are lightly or inadequately supervised.

Although I am testifying solely on behalf of PJM, several of the other RTO/ISOs, including the California ISO (operating in California), the Southwest Power Pool (operating in all or parts of the states of Kansas, Nebraska, Arkansas, Missouri, Oklahoma, New Mexico, Texas, and Louisiana), ERCOT (operating in the state of Texas) and the Midwest ISO (operating in 13 states in the Midwest) have authorized PJM to represent their concurrence in the attached statement reflecting sentiments and concerns similar to those stated in my testimony on behalf of PJM. *See Attachment A,* "Joint Statement of Identified RTOs/ISOs".

1. What Is PJM?

PJM is a FERC-regulated RTO responsible for ensuring the reliable and non-discriminatory planning and operation of the transmission grid and the fair and efficient administration of wholesale electric markets. The PJM region incorporates 56,000 miles of transmission lines, 1,250 generating plants and 6,000 substations. PJM has 250 intertie points with adjacent systems in the Eastern Interconnection, which means that along with managing the PJM system, our operators manage the interface between PJM and seven adjacent electric systems.

2. Overview of this Testimony.

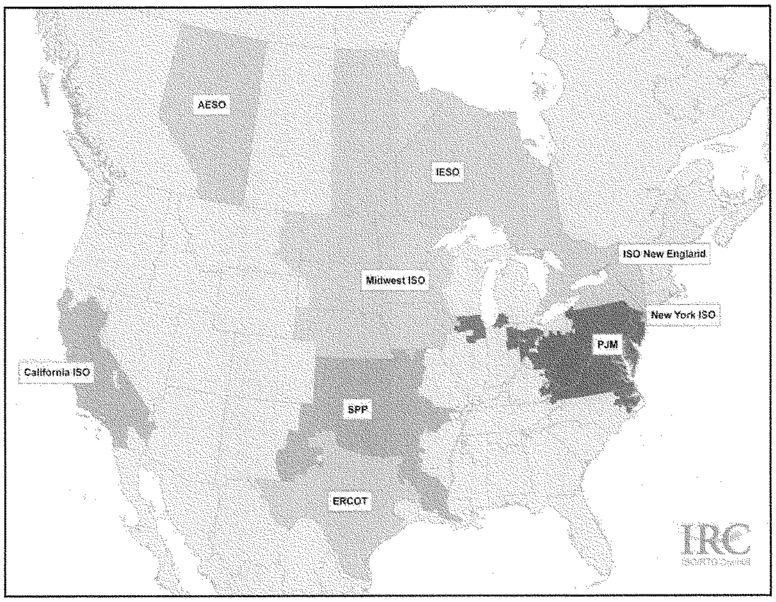
My testimony today will address the following areas:

- An overview of the extensive involvement of the FERC in both the creation and oversight of RTO/ISOs;
- A description of certain RTO/ISO forward markets which, some may contend, potentially are subject to oversight by the CFTC;
- The history of these forward markets, their extensive regulation by the FERC and the Energy and Commerce Committee's own historic exercise of jurisdiction over these markets;
- The incongruity of CFTC regulation over these markets and the problems that would arise from inconsistent, or worse, conflicting regulation should the CFTC seek to apply existing Commodity Exchange Act provisions to these markets; and
- Additional problems that would be caused by certain provisions in HR 3795 which, if left unattended, would exacerbate rather than resolve the confusion caused by potential dual regulation of these markets.

3. An Overview of FERC Regulation of RTO/ISOs.

PJM is one of seven RTO/ISOs in the United States. Together these entities serve over two-thirds of the nation. The map below depicts the respective operational areas for each of the RTOs.

Regional Electricity Markets



The 9 ISO/RTOs in North America serve two-thirds of electricity consumers in the United States and half of Canada's population.

Source: ISO/RTO Council

RTO/ISOs are a creature of FERC regulation and Congressional pronouncements. These independent electricity grid operators were established to fulfill Congressional policy by introducing competitive forces to liberalize the traditional monopolistic utility industry. The restructuring of the industry began with the Public Utility Regulatory Policies Act of 1978, which introduced nascent competition to the supply (generation) side of the industry. This legislation was followed by a succession of laws, including the Energy Policy Act of 1992, which began efforts to unlock the bulk delivery (transmission) side of the industry. From these beginnings emanated FERC's landmark Orders No. 888 and No. 2000 in 1996 and 1999 respectively. These orders demonstrate FERC's commitment to independent, "open access" operation of the power grid (not dissimilar from how air traffic controllers operate independently from individual airlines). FERC determined that RTO/ISOs were the best means to effectuate the open access provisions of the Energy Policy Act of 1992. While neither Congress nor FERC has ever compelled transmission owners to cede control over their transmission systems to independent operators, this Committee and Congress affirmatively encouraged this action by instructing FERC, through section 219(c) of the Energy Policy Act of 2005, to offer rate incentives to transmission owners that joined such organizations.[1]

This history of Congressional and FERC action introducing competitive forces to the utility industry is sometimes referred to as "deregulation." But as was often noted by then FERC Chairman Joseph Kelliher, this terminology, particularly when applied to describe the functions of RTO/ISOs, is entirely misleading. In point of fact, FERC's regulation of RTO/ISOs is pervasive. Moreover, unlike market regulators (such as the Securities and Exchange Commission and the CFTC) whose functions are probably best described as oversight based upon required disclosure, FERC is a traditional "rate regulator" with a mandate grounded in the Federal Power Act of 1935. What distinguishes FERC from those agencies overseeing the financial and commodity markets is its obligation to ensure that prices in wholesale electricity markets, *and* the terms and conditions of the various products and services used to establish prices in these markets, are "just and reasonable."

Each of the many functions performed by RTOs/ISOs as grid operators and market administrators is measured against this standard. Unlike clearinghouses, exchanges, boards of trade and the like, RTOs and ISOs cannot establish unilaterally their rules of operation provided only that those rules conform to broadly stated principles or best practices. Instead, RTOs/ISOs are subject to a FERC-administered program comprehensively regulating their planning of the transmission grid, their dispatch of generation operation of the grid, their compliance with reliability standards and their administration of the markets they operate. As a consequence, every material

[1] As the majority of the Texas grid is wholly intrastate and not interconnected with the rest of the Eastern Interconnection, the Electric Reliability Council of Texas (ERCOT) operates as an ISO in the state of Texas. Other than for regulation of ERCOT's compliance with national reliability standards, ERCOT is subject to the regulation of the Public Utility Commission of Texas rather than the FERC.

action taken by an RTO/ISO in performing these functions must be authorized by a rule. Every rule must be embodied in a tariff, which is designed through an open process with active participation by the customers subject to these rules. And every tariff provision must be filed with and adjudicated by the FERC to meet the requirements of the Federal Power Act.[2]

Moreover, RTOs/ISOs' administration of markets cannot be separated from their operation of the grid. Rather, RTOs/ISOs rely on the markets they operate as tools to more efficiently dispatch generation, manage congestion on the grid and ensure that electricity procured through the RTO and ISO spot markets is provided at the least cost to wholesale customers. RTOs/ISOs operate according to the principle that competitive forces employed in transparent market environments provide price signals that incentivize behavior consistent with the reliable day-to-day operation of grid.

4. Financial Transmission Rights in RTOs/ISOs.

(a) What is An FTR?

I have spoken thus far of "products" and "environments."[3] The RTO/ISO environments offer a product known as a "financial transmission right" or FTR to ensure "firm" transmission for electric transmission customers. Because this product is integral to the functioning of RTO/ISO markets, it has been in existence in PJM more or less since the inception of our markets. Despite successful operation of the FTR product, under FERC regulation, for more than 10 years in PJM, this product has recently drawn renewed attention from the CFTC.[4]

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[2] 16 USC 824d § 205.

[3] PJM does not voice an opinion as to whether certain Over the Counter transactions, such as those traded on the Intercontinental Exchange should be exempt from CFTC regulation, an issue addressed in H.R. 3795. In contrast to those products in those environments, the RTO/ISO environment and the various market products associated with the operations of the RTO/ISO, are already exhaustively regulated. The question as relates to RTO/ISOs is solely whether dual regulation of these markets by two different regulators with different missions and approaches is appropriate.

[4] Certain RTOs and ISOs operate forward capacity markets. These markets have even less of the attributes of a futures product than the FTR referenced herein.

The FTR is a forward right or obligation with some attributes seen in swap contracts and other attributes seen in futures contracts.[5] But several other essential attributes of FTRs are entirely unique so as to strain even the most liberal definition of a swap or futures contract, as those terms are employed, respectively, in the H.R. 3795 and the Commodity Exchange Act. Moreover, as I will explain, the FTR is a necessary component to the means by which RTOs/ISOs discharge their basic mission in providing open access transmission service and ensuring just and reasonable market outcomes for consumers – a mission whose regulation Congress has squarely entrusted to FERC.

With the establishment by RTOs/ISOs of organized wholesale electricity markets, a system was needed to prioritize equitably firm access to the grid. Transmission customers, typically utilities and competitive suppliers serving retail consumers, pay a priority charge to receive "firm" transmission service. Firm service allows these customers to deliver, with a high degree of certainty, energy from resources located in one place on the grid to meet consumption located in a different place on the grid. Yet the ability of any transmission system to deliver electricity from point A to point B is limited by the physical capability of the system to transfer power within the bounds of the thermal and voltage constraints governing reliable operation of the system.

The electricity markets operated by RTOs/ISOs typically employ a construct known as "locational marginal pricing" or LMP to signal demand for and attract supply of wholesale electricity. This means simply, that the real time price of electricity at point A may differ from the price at point B depending on whether the transmission system can deliver the lowest cost electricity generated by the marginal resource on the system to points A and B. As administered by RTOs/ISOs, LMP reflects the actual cost of delivering electricity from point A to point B in a manner corresponding to the physical flow of electrons on the grid between these two points. As compared to non-RTO/ISO transmission systems, LMP markets allow for a more efficient use of the transmission system by avoiding unnecessary curtailment of service and inaccurate and distorted pricing of transmission service whereby certain customers must subsidize in their rates

[5] As noted in the Joint Statement of RTOs/ISOs, Attachment A, other RTOs/ISOs make available similar products to what is known in PJM as a "Financial Transmission Right" or "FTR". Although the products may have a different name in each RTO or ISO, they all operate essentially the same.

the service provided to others. The provision of transmission service in LMP markets, however, exposes customers, including firm transmission customers, to price volatility when there is congestion on the grid.

RTOs and ISOs solve this problem by providing firm transmission customers with FTRs. In a nutshell, these financial transmission rights provide the holder a right to deliver power from point A to point B with protection against the risk that prices at point B might be higher than at point A. PJM allocates FTRs principally to utilities that serve retail customers (including cooperatives, municipal utilities and competitive retail providers in those states with programs to instill competition in retail service). These rights in total reflect the physical capability of the transmission system to deliver electricity; they are finite and their number is determined through analyses conducted by the RTO/ISO. The allocation of these finite rights is made to those transmission customers representing consumers that have paid for the fixed investment in the transmission system and are thus entitled to rights to the electricity transfer capability of this system. The FTR is the means by which RTOs/ISOs in LMP markets assure the provision of "firm transmission," consistent with FERC's open access directives, such that these customers are protected against the price volatility associated with multiple transactions occurring through constrained parts of the grid.[6]

As I hope is apparent, the FTR is inextricably linked to both the location priced energy markets and the provision of firm transmission service by RTOs/ISOs. It is also closely linked to the transmission system planning processes – the means by which the grid is expanded to meet growing need - another set of RTO/ISO functions subject to extensive FERC regulation. In theory, a transmission system could be built to accommodate all desired delivery transactions without congestion – which is to say, without a price difference between points A and B. In this system, FTRs would be unnecessary. In fact, some might comment that the role of the RTO/ISO should be to design, build and operate a transmission system so robust as to eliminate FTRs.[7] And while it is true that RTO/ISOs look for opportunities on their systems to eliminate points

[6] Pennsylvania-New Jersey-Maryland Interconnection, 81 FERC ¶ 61,257 at ¶ 62,240-241 (1997).

[7] In this respect, an RTO/ISO and its FTR product is quite distinct from financial institutions and the derivative instruments they design and market. While a financial institution is seeking to expand the market for the instruments it sells, RTOs/ISOs are continuously examining opportunities to enhance the physical capability of the grid so as to reduce the need for FTRs.

of chronic congestion by expanding transfer capability and thereby reducing the need for FTRs, in reality all transmission planners must strike a balance between the costs and societal tolerance for massive transmission infrastructure versus the costs of congestion.

(b) FERC and The Energy and Commerce Committee's Historic Oversight of FTRs.

FERC Oversight – The FTR is rooted deeply both in FERC regulation as well as in actions of this Committee and the Congress as a whole. For instance, virtually from the inception of PJM's markets, FERC directed the creation of FTRs as a means to allocate to transmission customers equitable access to the transmission grid. In PJM, the FTR product was approved by the FERC more than a decade ago upon the creation of PJM's organized markets in 1997. In Pennsylvania-New Jersey-Maryland Interconnection, 81 FERC ¶ 61,257 (1997), FERC found that FTRs "provide an effective method of protecting against incurrence of congestion costs when suppliers engage in transactions that use their firm transmission service reservations." Id. ¶¶ 62,257, 62,260. FERC also concluded that PJM's "allocation of FTRs" to transmission providers "to meet native load requirements (i.e. the customers for whom the transmission grid was planned and constructed in the first instance)" was appropriate. Id. ¶ 62,260.

In connection with these approvals, the Commission further found that there needed to be "a process for auctioning FTRs beyond those retained by . . . transmission customers." Id. ¶ 62,260. Accordingly, in 1999, and after considerable scrutiny, FERC accepted PJM's design of an FTR auction process that would both (i) provide an efficient means to distribute excess FTRs, and (ii) allow FTR holders the choice to sell those FTRs which they had been allocated and buy FTRs on different pathways that might more effectively hedge their power supply procurements. PJM Interconnection, L.L.C., 87 FERC ¶ 61,054 (1999).

Energy and Commerce Committee Oversight – Like the FERC, the Energy and Commerce Committee has been active in overseeing FTRs. Some may recall extensive debate, at the Committee level, over Section 217 of the Energy Policy Act of 2005 (the "native load" provision). Through Section 217, Congress directed FERC to:

> *exercise the authority of the Commission under this Act in a manner that ... enables load-serving entities to secure firm transmission rights (or equivalent tradable or financial transmission rights) on a long term basis for long term power supply arrangements made, or planned, to meet such needs.*

This direction to FERC (as well as Congress' choice of FERC as the implementing agency) shows Congress' intent to treat FTRs as tools available to load serving entities to meet their power supply needs rather than as another type of derivative instrument to be regulated separately and, perhaps, inconsistently, by the CFTC, which would claim no expertise or experience regulating the interstate transmission of wholesale electricity.

Congress further underscored the inextricable link of these rights to the underlying physical delivery of power to customers by creating, in Section 217(b) (2), an actual entitlement for load serving entities:

> *to use the firm transmission rights, or equivalent tradable or financial transmission rights, in order to deliver the output or purchased energy, or the output of other generating facilities or purchased energy to the extent deliverable using the rights, to the extent required to meet the service obligation of the load serving entity.*

Congress addressed how such rights are to be transferred by stating in section 217(b) (3) (A) and (B) that:

> *(A) To the extent that all or a portion of the service obligation covered by the firm transmission rights or equivalent tradable or financial transmission rights is transferred to another load-serving entity, the successor load-serving entity shall be entitled to use the firm transmission rights or equivalent tradable or financial transmission rights associated with the transferred service obligation.*

> *(B) Subsequent transfers to another load-serving entity, or back to the original load-serving entity, shall be entitled to the same rights.*

Congress also addressed the disposition of any excess rights not needed to meet an entity's load serving obligation by providing clear authority to FERC to address their disposition:

> *CERTAIN TRANSMISSION RIGHTS – The Commission may exercise authority under this Act to make transmission rights not used to meet an obligation covered by subsection (b) available to other entities in a manner determined by the Commission to be just, reasonable and not unduly discriminatory or preferential.*

Finally, Congress directed FERC to undertake a rulemaking to implement portions of Section 217, a rulemaking that led first to FERC Order No. 681, a 250-page final rule on long term FTRs, followed by FERC Order No. 681-A, a subsequent rehearing Order on the subject, and, finally, compliance filings by the RTO/ISOs.

In summary, through Section 217, Congress stated its intention that FERC regulate FTRs comprehensively, including their formation, initial allocation, and transfer among various entities, as well as the trading of any excess FTR rights available. PJM believes that Section 217 makes clear that the Congress intended for the FERC to act over FTRs because of their inextricable link to the underlying transmission grid and electricity market structure. The plain language of Section 217 indicates, in our opinion, Congress' desire that the FERC's regulation should be pervasive in this area, guided by its expertise in transmission regulation.

As a result, PJM believes clarification is sorely needed given the uncertainties introduced as a result of the potential for an expansive reading of the existing Commodity Exchange Act and the provisions of H.R. 3795 to introduce overlapping regulation by two separate agencies.

5. <u>The Problem Of Competing FERC and CFTC Jurisdiction.</u>

At the outset of my testimony, I commended this Subcommittee's focus on the details of financial market reform as an admonition to lawmakers to keep "their eyes on the ball." Aside from reasons of interagency comity, inefficient duplicative regulation, and distraction, there are immediate and practical reasons to delineate clearly in statute the respective regulatory responsibilities of FERC and the CFTC when it comes to RTO/ISO products and environments.

The notion of dual or overlapping jurisdiction in this area is challenged by the exclusivity of jurisdiction afforded to the CFTC through the Commodity Exchange Act and reinforced through H.R. 3795. For instance, the existing Commodity Exchange Act states (and would continue to so state under H.R. 3795) that where a contract falls under provisions of the Commodity Exchange Act, it is subject to the "*exclusive jurisdiction*" of the CFTC. See CEA § 2(a)(1)(A), 7 U.S.C. § 2(a)(1)(A). This grant of exclusive authority raises at least the potential that FERC (and this Committee) could be divested of any jurisdiction over the FTR and any market settlement functions involving FTRs that the CFTC might regard as "clearing." Yet, as I trust is evident from this testimony, the FTR does not stand in isolation from other market, grid operation and grid planning functions performed by RTOs/ISOs and that are regulated comprehensively by FERC. The FTR is not merely decorative to the architecture of RTO/ISO programs; it plays an integral role in the basic design of these programs.

At least four concerns are apparent.

First, the "exclusivity" provision of the Commodity Exchange Act could cause the FTR and its transaction and settlement functions being subjected to *less* control under CFTC oversight than they are today under FERC rate regulation. FERC's regulatory paradigm of tariff filings and agency adjudication is considerably more extensive and intrusive than the market oversight performed by the CFTC. Neither the RTOs/ISOs that administer the transacting and settlement of FTRs nor industry participants in the FTR markets support an outcome that would result in less regulation of this product.

Second, if the FTR is subjected to settlement, clearing and credit risk management principles well suited for many financial instruments, but incongruous to FTRs, the future of the FTR in RTO/ISO markets is quite uncertain. Again, this consequence might not be terribly problematic if the FTR could be regarded as a "nice to have" risk management tool, but hardly indispensible to the needs of wholesale customers in managing their power purchases. As this testimony has tried to show, this is not the case. In fact, the FTR is essential to FERC's policy of ensuring that transmission customers, in RTO/ISO environments, can obtain firm open access service needed to meet the demands of their retail consumers. The FTR's importance to this objective is underscored by the attention this Committee paid to the product in the Energy Policy Act of 2005.

Third, while the FTR auction markets attract some non-traditional energy market participants, including commodity trading firms, it would be a mistake to therefore assume that these markets can be "cleared" under the Derivative Clearing Organization "core principles" currently in place under the Commodity Exchange Act.[8] The FTR is infrequently priced through pre-scheduled auctions that generally occur once a month. Buyers of FTRs are not in any legal sense matched with sellers. While PJM manages the credit risk exposure presented by holders of some FTR positions, these positions are not "marked-to-market" by PJM and there is no workable method for variation margining. Due to these and other attributes unique to FTRs and despite much exploration, PJM has never found a CFTC-registered clearinghouse, including those active in clearing energy commodity transactions, interested in or able to clear the FTR positions of PJM's market participants. So, assuming that the practical consequences of CFTC oversight do not eliminate outright the FTR as PJM fears, the alternate scenario is one where the CFTC in bringing its expertise in overseeing market clearing and settlement, could spend much time and resources requiring registration and reporting, only to find that no change or "improvement" to how our FTRs are transacted, settled and credit risk managed can be achieved in a real and practical sense.

Fourth, instruments traded in a manner or in an environment contrary to the requirements of the Commodity Exchange Act are, in a sense, *ultra vires*, and their enforceability is at risk of challenge.[9] Somewhat ironically, the CFTC's renewed interest in the established FTR products, motivated presumably by a desire to reduce perceived systemic risk associated with FTR markets, may be having quite the opposite effect. Should the CFTC claim that the FTR is now jurisdictional under the Commodity Exchange Act, the legal integrity of these products becomes less certain and a risk materializes that a counterparty with outstanding obligations under an FTR might assert

[8] CEA § 5b(c)(2), 7 U.S.C. § 7a-1(c)(2).
[9] See, e.g., Transnor (Bermuda), Ltd. v. BP North America Petroleum, 738 F. Supp. 1472, 1990 U.S. Dist. LEXIS 4423, Comm. Fut. L. Rep. (CCH) P24829, 1990-1 Trade Cas. (CCH) P68998 (S.D.N.Y. 1990).

that the obligation is void and unenforceable. Injecting this risk into the FTR markets is completely unnecessary and easily avoided by Congress drawing clear jurisdictional bounds that recognize FERC's settled authority in this area.

6. Further Complications Caused by Certain Provisions of H.R. 3795.

In closing, I would not want to leave the Subcommittee believing that the RTO/ISO concern as to the uncertain prospect of competing jurisdiction is confined to an ambiguous interplay between the existing Commodity Exchange Act and Federal Power Act. In an understandable effort to empower the CFTC with more far-reaching authority to oversee financial instruments and trading environments that today escape meaningful regulation, H.R. 3795 employs broadly worded definitions and sweeping language. Such an approach is probably necessary in order to anticipate the evolving nature of commodity market instruments and innovative mechanisms for trade execution. But this approach also aggravates the existing problem, in particular, by creating heightened uncertainty that the FTR could be regarded as a "swap." Attached here as Attachment B is a delineation of what PJM regards as the most problematic consequence to RTO/ISO operations as a result of existing provisions in H.R. 3795.

7. Conclusion.

Again, PJM thanks this Subcommittee for the opportunity today to share our thoughts on the potential for FERC and CFTC dual and potentially inconsistent regulation of certain RTO/ISO products essential to load serving entities and thus retail electricity customers. PJM's fellow RTOs/ISOs that have endorsed the statements set forth in Attachment A also appreciate your consideration of their views. We stand ready to assist this Subcommittee as it reviews this important issue.

ATTACHMENT A

JOINT STATEMENT OF CALIFORNIA ISO, ELECTRIC RELIABILITY COUNCIL OF TEXAS ("ERCOT"), MIDWEST ISO, PJM INTERCONNECTION AND THE SOUTHWEST POWER POOL

1. Financial transmission rights (FTRs) are an integral part of the provision of firm transmission service. Although they go by different names in each of the RTOs and ISOs, the products are essentially the same. FTRs are awarded, initially to load serving entities (i.e., providers of electricity to residential, commercial and industrial customers) and others who contribute to the fixed costs of the grid through their payment of transmission rates. These customers have historically shouldered the embedded costs of building and maintaining the transmission system.

2. FTRs are a financial instrument that can be created only by the RTOs/ISOs as their number and composition is determined based upon the transmission system topology and the physics of physical power flows. As such, they differ substantially from standardized, stand-alone derivatives in which parties exchange cash flows based upon price changes tied to a notional quantity of a commodity, but not inextricably tied to the actual delivery of a physical commodity. Moreover, because FTRs are inextricably intertwined with the electricity markets and reliability functions of RTOs and ISOs, it is impractical and inefficient to regulate FTRs separately or differently from the underlying provision of electric transmission service.

3. FTRs have been regulated by the FERC (and in the case of ERCOT, the Public Utility Commission of Texas) since their inception in the PJM market over 10 years ago. In addition, Congress determined in EPACT 2005 that FTRs are integrally tied to meeting the power procurement needs of load serving entities. FERC not only regulates FTRs, but FERC *directed* PJM and other ISOs/RTOs to develop a hedging tool to allow load serving entities to manage congestion risk associated with their longer term power procurements. By the same token, the portion of the Texas grid served by ERCOT is entirely intrastate. As a result, regulation of FTRs in Texas is undertaken by the Public Utility Commission of Texas in a fully integrated manner.

4. Duplicative or conflicting regulation of financial transmission rights is not in the interest of consumers. FERC (and, in the case of ERCOT, the Texas PUC) should be able to maintain their respective roles as the regulators of these products given their pervasive regulation of both ISO/RTO markets and the provision of transmission service by ISOs/RTOs. This regulation comprehensively spans the full span of physical grid operations – from the planning of the transmission grid, to ensuring day to day reliability of the grid, to the dispatch of generation and demand resources to meet consumption in real time. The uncertainty created by the unclear regulation of FTRs under

current law as well as complications created by the provisions of the new legislation should be addressed in the legislation now being considered.

5. Although the RTOs and ISOs do not believe that Congress intended there be two regulators of the FTR product, the RTOs and ISOs do believe that cooperation is needed in areas where activities in a CFTC-regulated market may affect a FERC or Texas PUC- regulated market and vice versa. This is not an area of regulatory overlap, but instead an area where the exercise of the authority of each regulator over their *respective* jurisdictional market should be coordinated and complementary. As a result, cooperation, including data sharing, should be required by this Congress in those areas where FERC's or the Texas PUC's regulation of the RTOs and ISOs has an impact on CFTC's regulation of markets under its jurisdiction and vice versa.

ATTACHMENT B

IMPACT OF PROVISIONS OF H.R. 3795

H.R. 3795 broadly defines "swaps" and provides that swaps are under the "exclusive jurisdiction' of the CFTC. If FTRs are treated as "swaps" under H.R. 3795, then:

- FTRs would be subject to the *exclusive jurisdiction* of the CFTC – this would seem to have the effect of divesting FERC of any jurisdiction over FTRs;

- Under the Treasury, House Agriculture Committee and Senate Banking Committee legislative proposals, FTR contracts would have to be traded either on a CFTC-regulated Derivatives Clearing Market, such as NYMEX, or a swap execution facility – this could prevent PJM from making ARRs directly available to load serving entities as is currently anticipated by Section 217 of the Energy Policy Act of 2005;

- FTR transactions would have to be cleared on a CFTC-registered Derivatives Clearing Organization and would be subject to initial margin and daily variation margin requirements – this would impact FERC's stated goal of ensuring non-discriminatory access to the FTR markets and impact small utility systems seeking to obtain FTRs to meet their service obligations;

- FTR holders could be subject to CFTC information, recordkeeping and position limit requirements which could impact the ability of Load Serving entities to procure sufficient FTRs to hedge their congestion risk; and

- CFTC's ability to grant exemptions from these requirements and others in the Commodity Exchange Act would be severely curtailed.

Mr. MARKEY. Thank you so much. We appreciate it, Mr. Duane. The chair will now recognize himself for some questions.

Ms. Moler, your position is that FERC should have exclusive authority over RTO products and services. That is a much more aggressive position then Mr. Waxman and I and Mr. Upton and Mr. Barton have taken. We basically say lets preserve FERC's authority and where there is overlapping authority, let the FERC and the CFTC work it out. Why is your approach better in your opinion?

Ms. MOLER. My concern is born of the language in the bills that have gone through the two other committees. Under the Commodity Exchange Act, if the CFTC has jurisdiction over a transaction, it supplants other agencies' jurisdictions. They have exclusive jurisdiction and I do not understand having negotiate a number of Memoranda of Understanding when I was at FERC and when I was Deputy Secretary of Energy how one agency that has preemptive authority over transactions that are currently regulated by another agency, how those two agencies can successfully negotiate a Memorandum of Understanding.

So if you give the CFTC authority over or if they claim authority over things like Financial Transmission Rights, that trumps FERC's authority and FERC's ability, at least arguably, and FERC's ability to allocate transmission rights and the like, and I worry about that. I understand that they have under the Energy Policy Act of 2005, authority to look at fraud and manipulation but they wouldn't have anything to do with those transactions. That is why I am not as comfortable with the MOU approach.

Mr. MARKEY. OK, great.

Mr. English, what would be the practical impacts on consumers and your members if FERC's authority over Financial Transmission Rights and other RTO products were eliminated as a result of the pending bill?

Mr. ENGLISH. I think the problem is we don't know, Mr. Chairman. We have an agency that really is not equipped to regulate these markets and certainly that would raise questions I think about as I mentioned earlier a very volatile marketplace and how well it would work so I have serious questions whether it would work.

Mr. MARKEY. Great.

Mr. Shelk.

Mr. SHELK. As I indicated, these are the markets in which we receive the revenue on which we rely to operate and invest so our concern would be, depending on what aspects of the RTOs and the ISO markets the CFTC might consider under its purview, and as Ms. Moler said this is the later enacted statute so if it stands as it is today, we would be subsequently basically reaffirming and even strengthening the CFTC's role which would raise concerns in our minds about the revenue strengths we depend on.

Mr. MARKEY. OK, great.

And, Mr. McCullar.

Mr. MCCULLAR. We heard the two chairmen discussing the very issue and it is our position that FERC should maintain primary jurisdiction in these markets but CFTC can be helpful in an oversight mode and in, frankly, combining resources to deal with these problems could only help the markets and the consumers.

Mr. MARKEY. Great, thank you.

Mr. Duane, what changes would be made if PJM had to adhere to the principals in place under the Commodities Exchange Act as a derivative clearing organization? What effect would those requirements have on the marketplace?

Mr. DUANE. Let me first state I am not sure we would be able to comply with those directives. Again, those directives are designed to promote transparency, to limit lower risk and to preserve the integrity of markets. That is well and good and those are objectives that we share that the FERC shares as well and we just use different tools to do that. If we were forced somewhat akin to a square peg into a round hole, I am very concerned that the products themselves wouldn't survive. Alternatively, there would be sort of qualification given to such a degree that I am not sure anything will have improved or changed. We have got what we have got today. It is workable. I think that is the answer to the question.

Mr. MARKEY. Great, thank you, Mr. Duane, very much.

My time has expired. The gentleman from Michigan, Mr. Upton, if recognized.

Mr. UPTON. Thank you, Mr. Chairman. I just want to say as I listened to the testimony of all five witnesses, it really does seem like we are at Fox News, fair and balanced. Everyone was on the same page, including Mr. English, former Ag Committee member, right, correct? Have you talked to Chairman Peterson about this? Has anyone here?

Mr. MARKEY. The CFTC, by the way, has its own channel one floor down that it can turn to.

Mr. UPTON. Yes, has anyone here, I should ask, has anyone here in the audience from the Ag Committee? Going once, no hands, OK.

Mr. ENGLISH. Well, Mr. Upton, as I pointed out I have high praise for Chairman Peterson.

Mr. UPTON. I know you do. I know you do.

Mr. ENGLISH. There is just this one little narrow area. It is not much, just a little tweaking here and there would take care of the problem.

Mr. UPTON. Yes, you know, Mr. Wellinghoff, Chairman Wellinghoff in one of his answers talked about uncertainty creates more risk and clearly I think that is what this 3795 really does. It does need to be maybe a little more than tweaked but it needs to be fixed. There is an old saying if it ain't broke, don't fix it but in fact, I think this would really send us back and the bottom line would be that the extra burden would probably increase rates for most America. I know PJM, I thought stood for Michigan in this thing but that is all right. But it would, the burden would in fact have the potential of increasing rates for all consumers is that—does anyone disagree with that? So and, you know, the electric industry is unified, right? Is there anyone else that is not on the same page, any major organization that is not with your testimony, right?

Mr. SHELK. And as you know that is a unique development in our system, the fact that we are unified.

Mr. UPTON. We are still working on cap and trade to make sure we get people back in the corral but we will see what happens. But yes, I just want to say I appreciate your testimony and I look forward to working with Chairman Markey and Waxman and Barton to fix this problem before it gets to the House floor because it will increase rates and that is the last thing that, you know, as I look at Michigan's economy and the nation as well. We don't need this. We really don't need this.

Ms. MOLER. Mr. Upton, several earlier participants have mentioned an analysis that Exelon has done by looking at what would happen if our types of transaction were required to be cleared and our analysis shows a rate increase of between 5 and 15 percent. With your permission, I would like to put an example or two in the record that shows how we came up with those numbers based on some real typical kinds of power transactions.

Mr. MARKEY. Without objection, so ordered, thank you.

Mr. UPTON. Thank you and I have no further questions. I yield back.

Mr. MARKEY. The gentleman yields back his time.

And the chair recognizes the gentleman from Michigan once again, Mr. Stupak.

Mr. STUPAK. Thank you, Mr. Chairman. Sorry I missed the testimony. I had to take another meeting but I have been asking the last time I asked about the swap clearing for end users so let me ask this question this way. Bona fide hedgers are participating in derivatives markets for commercial purposes and really are not the cause of our excessive speculation as I call it in the energy markets. Electric utilities are not the cause of our current financial crisis, however in the legislation exemption from a swap clearing for end users also allows large financial institutions that serve as your counterparties to also remain off the hook for stricter oversight. So my question was this and whoever wants to chime in, please do, would you support a change in the legislation that allows a bona fide hedger, including electric utilities to remain exempt from clearing requirements but mandating that tier one financial companies clear their swap transactions on a regulated market? All right, Glenn, it looks like you are ready to go.

Mr. ENGLISH. Our concern still is the fact, you know, we are very small and certainly whenever you look at the size of these markets you can't hardly see us with a magnifying glass but these are very important markets to us to hedge our risk. We don't have the kind of capital at hand to be able to handle a great deal of risk and it really puts us in a bind for this. Anything that would increase those costs, I think are going to push our people out of those markets and it increases risk to our members considerably.

Mr. STUPAK. But if we exempt you out and let your counterpart though it would still regulate that.

Mr. ENGLISH. That the key word here is what kind of impact is that going to have on you, yes.

Mr. SHELK. Mr. Chair, we support Mr. Stupak's interest in transparency. The question is how do you do it and the concern with the tier one provision is as Chairman Gensler indicated most of our counterparties are the larger banks so they can be.

Mr. STUPAK. Counterparts.

Mr. SHELK. So under the version that you have suggested essentially the tier one bank wouldn't post the collateral, we would have to post the collateral as the counterparty to the tier one institution and as I indicated earlier, the problem with that is it would tie-up, and the examples we have come up with about an average a quarter of the capital of the end user so we fully agree with your comments that the electric utilities and other generators didn't cause the problem. We think the way to get to your transparency goal which we share because we are in the market too, is to have a data repository so that information on these trades would be available to the CFTC and others, and the problem with electricity is it is very customized. These products are traded over hundreds of different nodes around the country so it doesn't really lend itself, the CFTC doesn't lend itself to the corn example, and the T-bill example and kinds of commodities that the chairman indicated.

Mr. STUPAK. You know, we will try to get to these large pools coming in and driving up those prices and even if they are your counterpart, they still fluctuate.

Mr. SHELK. That is why we agree with you. You can help us so we would like to see the data repository as the way to put on the bulletin board to the CFTC so they would know what is happening in these markets whereas Chairman Gensler said today, they don't. I think that would get at what you are trying to accomplish.

Ms. MOLER. Mr. Stupak, there are lots of estimates floating around about how much this costs but if you require these transactions to be cleared on exchange, they have margin requirements, and we are talking billions of dollars of additional cost to our sector. And you can't just exempt Exelon, or PECO, or Com-Ed, or DTE, or anything but not their counterparty because if their counterparty has to go through the clearing process then drags the reluctant counterparty with them. Both parts, if one is subject to it, then both parts of the transaction get subject to it and that is where the costs come from. So yes, I understand it may not be popular to think about exempting some of the large investment houses but they are our counterparties and we need these markets to be robust. Deep liquid is the phrase that our guys always use but that is the way we save our customers money.

Mr. STUPAK. But also led to our financial meltdown.

Ms. MOLER. Not with these kinds of products. They, I mean the housing derivatives and mortgage securities, et cetera, et cetera, but I don't think that you find that transactions for FERC RTO markets and hedging instruments used by our sector have been part of that problem.

Mr. STUPAK. Well, I think Mr. Waxman might disagree with you on that after the California electric debacle and again, I am not saying you caused it but when you got that much money moving around and as quickly as it is moving around that is where your excess speculation comes in, and so how do we do it that keeps you, a bona fide hedger, you are bona fide. These other folks come in with this money, they are not bona fide. They are just in there to make money and as long as if they are not cleared anywhere and even depositories is the place to look at. I am not quite sure but I am still saying making them clear. I am still trying to—I am still wrestling with that one.

Mr. MCCULLAR. If I could have a comment that may give some comfort here.

Mr. MARKEY. Please do it quickly because our roll calls are about to start.

Mr. MCCULLAR. We work in the light in our industry. It is very open and it is very transparent, and when we have these counterparties, we require them to come into the light with us and especially public power systems or community-owned systems. We would not participate as a counterparty in something that was not in the light and transparent and I think that should give comfort.

Mr. MARKEY. Gentlemen, the former police officer from Michigan's time has expired, a former state trooper. He prefers that everything be in the light as a former state trooper. It works better for crime prevention and detection.

The gentleman from Louisiana, Mr. Scalise, is recognized.

Mr. SCALISE. Thank you, Mr. Chairman.

I would just ask for the whole panel if, I know a few of you made some different remarks about this in your statements but if you could each say first if you do think there would be any increases to consumers by this legislation and if so, what rough percentage, and if you can just go across starting with Ms. Moler.

Ms. MOLER. Yes, and our best estimate is somewhere between 5 to 15 percent to have a clearing requirement.

Mr. SCALISE. Thanks.

Mr. MCCULLAR. Thank you and from our point of view it would be at least a 5 percent increase in cost of operations and those costs would have to be passed onto the consumers.

Mr. ENGLISH. In looking at the issue that we are talking about today, we have a major concern over the law of unintended consequences and any time you leave a hole open with this kind of a question, you are likely to have increased costs and unintended consequences.

Mr. SHELK. The short answer is yes for all the reasons you have heard.

Mr. DUANE. From the RTO perspective, it would frustrate programs that are essential to the delivery of services to our customers. That would increase cost and perhaps take away the programs altogether.

Mr. SCALISE. OK and then earlier we talked to you about capital and how this may tie-up capital that would make it more difficult for companies to become more energy efficient. Can each of you just briefly touch on that, as well?

Ms. MOLER. I agree with Mr. Shelk's earlier observations on that subject. We are like all businesses these days we are very careful where we put our capital. If we have to put it all on margin requirements, we won't be able to do other new projects, transmission projects, new generation. We are building a solar project in South Chicago. The money there wouldn't be there.

Mr. MCCULLAR. I agree with Ms. Moler's statement. It is a capital-constrained environment now for all the reasons we know. This would only aggravate that situation.

Mr. ENGLISH. And I also agree but I also think that it could have the additional complication of the flow of power in this country.

Mr. SHELK. On the point of the capital it is not only the amount, it is the uncertainty because you have to post margin in the beginning and as the transaction continues over time so it is not just the amount which in and of itself is significant but it is also the fact that it would change over time. Again, we think unnecessarily so; we can accomplish the transparency goals that Mr. Stupak understandably wants to achieve without having to tie-up roughly a quarter of each company's capital in the clearinghouse to get the transparency that you should want.

Mr. DUANE. And again, from the RTO perspective and the FTR, the FTR is essential to assist people in long term contracting. Long term contracting provides a stream of revenue necessary to support capital formation and investment of any technology so yes, again, if the program is threatened the whole unintended consequence flows through the whole system.

Mr. SCALISE. Thanks and then I will just throw this one out there for anybody that wants to take it. Do you believe that some market participants would cease hedging exposure if clearing were mandatory due to the increased cost associated with exchange trading and if that were the case would that even bring more risk into the market if anybody wants to?

Mr. ENGLISH. Yes, as far as electric cooperatives are concerned, we wouldn't have a choice.

Mr. MCCULLAR. Yes, the capital constraint, public power systems would basically be priced out of using those tools and it would impact our customers.

Ms. MOLER. We use hedging to level out the prices we charge our customers. If we can't hedge, we are going to charge them more, and we will also be less likely to enter into long term contracts.

Mr. SHELK. The short answer is yes, it would.

Mr. DUANE. The only point I will add is to remind everyone here that electricity is an extraordinary volatile commodity and the ability to hedge that price volatility is essential.

Mr. SCALISE. And, of course, benefits consumers too; I appreciate all of your candor and I yield back.

Mr. MARKEY. The gentleman's time has expired.

The chair recognizes the gentleman from Michigan, Mr. Dingell. You, Mr. Chairman, would be the last member recognized to ask questions. I thank the chair for that and I want to thank all of our witnesses for their testimony today. The hearing has underscored the need for the derivatives bill reported out of the House Agriculture Committee to be modified so it does not interfere with the ability of the Federal Energy Regulatory Commission to oversee electricity and natural gas markets. We have heard about the potential for the bill to disrupt the RTOs as well as mechanisms used by many RTOs. These include Financial Transmission Right used to hedge the volatility of transmission prices forward capacity markets use to ensure that there is sufficient generation capacity and potentially demand side energy management programs. We have also heard about the potential for this legislation to exacerbate an existing dispute over the reach of the FERC's antifraud and antimanipulation authorities. Clearly, we need to correct these problems and work with the members who have come here today on a bipartisan basis and with the witnesses who have been gracious enough to come here today to testify as expert witnesses so we thank you all.

And with that and the thanks of this committee, this hearing is adjourned.

[Whereupon, at 3:45 p.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

Congressman Gene Green
Subcommittee on Energy and Environment
"Impacts of H.R. 3795, the Over-the-Counter Derivatives Markets Act of 2009, on Energy Markets"
December 1, 2009

Mr. Chairman, thank you for holding today's hearing on the "Impacts of H.R. 3795, the Over-the-Counter Derivatives Markets Act of 2009, on Energy Markets."

Last year's collapse of the U.S. financial markets left our economy debilitated, but not defeated. It taught us, among other lessons, that opaque markets coupled with lax federal oversight are a recipe for an economic disaster.

Closer attention must be paid to the largely unregulated "over-the-counter" – or OTC -- derivatives markets which are a rapidly growing segment of the marketplace.

In recent years, the percentage of physical hedgers – or end users -- who actually rely on the market to lock in future selling prices is being dwarfed by the entrance of speculators who never take physical delivery of energy supplies.

Some estimate that commodity index speculation has increased 1900 percent since 2003, and the number of futures contracts has also hit record levels.

Foreign boards of trade, which operate outside of the jurisdiction of the CFTC or FERC, are also heavily trading West Texas Intermediate futures contracts here in the U.S.

Congress has a responsibility to modernize our financial regulatory system to bring transparency and oversight while protecting consumers against any "gaming of the system" or price manipulation.

However, we must use extreme caution so that any proposals actually target the root of the systemic risk and do not unnecessarily hamper the proper functioning of energy markets or duplicate existing regulatory frameworks.

H.R. 3795, approved by both the House Agriculture and Financial Services Committees, seeks to comprehensively regulate, for the first time ever, the OTC derivatives marketplace.

While I am pleased both versions of H.R. 3795 include exemptions permitting energy end-users to continue to engage in OTC transactions to legitimately hedge risk for their businesses, I have concerns these exemptions are not more explicitly protected in the bill.

I am also concerned with creating overlapping or duplicative regulatory responsibilities for both the CFTC and FERC.

Congress has repeatedly recognized FERC as the exclusive regulator of regional transmission organizations (RTO's) and independent system operators (ISO's), and has provided FERC authority to ensure just electricity rates and to protect against market manipulation in natural gas and electricity markets.

Without just cause, it does not seem prudent to have RTO's and ISO's – and the transactions within these energy markets – subject to two federal regulators.

Mr. Chairman, I hope today's panel will help flesh out these very complex issues, and I look forward to working with you and other Members on improving the transparency of our energy markets.

If we can shine the bright light of accountability on commodity transactions, we can help foster fair, open and transparent markets for American consumers, businesses, and utilities.

Thank you. I yield back the balance of my time.

Opening Statement of the Honorable Joe Barton
Ranking Member, Energy and Commerce Committee
For Subcommittee on Energy and the Environment Hearing:
"Impacts of H.R. 3795, the Over-the-Counter
Derivatives Markets Act of 2009, on Energy Markets"
December 2, 2009

Thank you, Chairman Markey and Ranking Member Upton, for holding this important hearing on the Over-the-Counter Derivatives Markets Act of 2009, H.R. 3795. Before this bill goes to the floor, it is important that we discuss and correct its negative impact on energy markets.

H.R. 3795 would allow the U.S. Commodity Futures Trading Commission (CFTC) to encroach on the Federal Energy Regulatory Commission's regulation of energy markets and freeze FERC out of its traditional regulatory purview. In fact, the bill could actually remove some Regional Transmission Organizations (RTO) market functions from under FERC's jurisdiction. Last month, FERC Chairman Wellinghoff expressed his concerns about the CFTC by saying, "Recently they've also started to look at things within the RTO markets, which would include financial transmission rights, and I believe that's completely outside of their purview." I am equally concerned that this bill reflects the CFTC's expansionary mood and it may be looking to poach authority from other agencies.

Financial transmission rights serve a useful purpose. They allow customers to protect against the risk of price increases due to congestion in the grid. Congress specifically addressed financial transmission rights in the Energy Policy Act of 2005 as one way of ensuring that people who've paid to build transmission capacity can benefit fairly from their work and investment. Nobody ever contemplated financial transmission rights being regulated as energy derivatives. And there is no reason to do so. These are not products that pose systemic risk.

I know that some in the Administration don't want to let a good crisis go to waste, but these products did not contribute to the financial crisis. That honor is reserved for the category of derivatives that Warren Buffett called "financial weapons of mass destruction," which fortunately did not and do not include financial transmission rights.

Volatility in the price of fossil fuels is a key concern of this Committee. I believe that the futures and derivatives markets should be transparent with clear rules guarding against the manipulation and unbridled speculation that can harm consumers. We should have strong penalties to deter bad actors from corrupting these markets. That's why we gave FERC anti-manipulation authority with strong penalties in the Energy Policy Act of 2005. The problem with H.R. 3795 is that financial products such as financial transmission rights are already closely regulated by FERC, an experienced regulator with adequate authority.

We will also hear concerns from the utility industry regarding the increased costs that would result from H.R. 3795. Utilities say that, if all of these types of transactions were to be conducted on-exchange, prices could increase in the range of 5-15%. If we foolishly pass both this legislation and the Waxman-Markey cap-and-trade bill into law, family electric bills will be headed into the stratosphere. The recession that has dragged on for months is not over yet, and everybody here understands that jobs will be the last part of the recovery. I'm not sure there's ever a right time to add to the burden of struggling families who work for a living, but I know this is exactly the wrong time. .

I strongly urge that this legislation be corrected to preserve FERC's existing authority over energy markets.

Thank you, and I yield back the balance of my time.