Testimony of Jeffrey L. Walker

Chief Risk Officer, Alliance for Cooperative Energy Services Power Marketing LLC

before the Committee on Agriculture, Nutrition and Forestry of the U.S. Senate

Washington, DC

May 14, 2015

Chairman Roberts, Ranking Member Stabenow, Members of the Committee, thank you for inviting me to testify today on the regulatory burdens impacting energy industry end-users and market liquidity.

My name is Jeff Walker, and I am the Chief Risk Officer of Alliance for Cooperative Energy Services, or "ACES" for short. ACES is owned by 21 not-for-profit electric cooperative power supply Members who use energy commodity services provided by ACES to participate in the wholesale electric and natural gas markets. Not only are ACES' Member-owners commercial end-users, but as not-for-profit cooperatives, they are also ultimately owned by the retail electric consumers they serve in 27 states, including Arkansas, Colorado, Georgia, Indiana, Iowa, Kansas, Kentucky, Minnesota, Mississippi, North Carolina, and Ohio. ACES is headquartered in Carmel, Indiana, and has office operations in Minnesota, North Carolina, and Arizona.

U.S. consumers expect some volatility in the price of gasoline they pay at their local gas pumps from week to week, but when consumers get their monthly

electric bill, they've always expected price stability. Consequently, one of ACES' primary goals of helping our Member not-for-profit electric utilities participate in the wholesale energy markets is to manage this price volatility. Sometimes we can use physical transactions to lock in electric energy or generation fuel prices, however, financial transactions must also be used when appropriate to lock in prices, or to manage the price and supply volatility of the commodities our Members use to produce electricity and to serve electricity to consumers.

ACES and its 21 electric utility owners care about the Commodity Futures Trading Commission's (CFTC's) jurisdiction over the energy and energy derivatives markets since CFTC is a regulator of not only the financial markets we use, and financial transactions we enter into, but also because in 2012 the CFTC, much to our surprise, decided to define a portion of our physical transactions as being jurisdictional "swaps" too.[1] I'll address this fundamental jurisdictional issue in a moment.

Since 2010, the Dodd-Frank "Wall Street Reform" Act, and dozens of new CFTC Dodd-Frank-related regulations and interpretations have impacted our energy commodity transactions by adding significant regulatory burden on energy market commercial end-users doing business on Main Street. What's perplexing about this to ACES is that the 2008 financial crisis was not caused by commercial

end-users, by activity in the energy markets, nor even by activity in any physical commodity markets. We see no reason why energy market commercial end-users like electric cooperatives and other utilities should be treated by Congress or the CFTC as though they were the cause of the 2008 financial crisis. I'll take a moment to highlight some of the challenges our electric cooperatives have faced under Dodd-Frank.

- In 2012, CFTC stated in a rulemaking that it would not provide a bright-line test for compliance of its Dodd-Frank regulations because of concerns that doing so would provide a "roadmap for evasion" to market participants.[2] This statement appears to target financial entities who may have exploited regulatory loopholes prior to Dodd-Frank. However, the CFTC's approach has resulted in Dodd-Frank regulations that are vague and ambiguous; making understanding such regulations costly, and compliance by commercial end-users confusing, time-consuming, challenging and – again – very expensive.
- Understanding the do's and don'ts has also meant that each new commercial end-user that wants to become a market participant must piece together a patchwork of dozens of final rules and CFTC interpretations, with dozens of CFTC Staff No-Action Letters that partially delay or waive enforcement for specific categories of companies, or more broadly.[3] The CFTC has not provided

any source that unifies or maps all companion releases together, leaving end-users in doubt about whether they've uncovered all their relevant blind spots throughout CFTC.gov addressing Dodd-Frank regulations.

- In 2012, CFTC imposed an entirely new set of obligations requiring commercial end-users to keep records of pre-trade written communications. Prior to Dodd-Frank, only fiduciaries serving market customers and holding customer funds were burdened this way. This occurs because the CFTC's rules were revised to include certain commercial end-user counterparties or market participants as "members" of trading venues – a status previously reserved for market intermediaries having a fiduciary duty with customers, and holding customer funds.[4] "Member" status now applies to commercial end-users only because a trading venue happened to provide market access directly to its users, as opposed to setting up access through a broker- or intermediary-sponsored scheme. Commercial end-users with direct market access also get saddled with much more onerous and non-standard records retention periods traditionally targeted at customer fiduciaries, not only for pre-trade communications and financial derivative records, but also all of their related physical commodity commercial activity.[5] Even worse, this requirement is not confined to the direct access trading venue. This ambiguous rule may be interpreted to overlay this onerous burden on the entire business dealings of a

commercial end-user's jurisdictional commodity activities. And a commercial end-user can enter this recordkeeping briar patch by making just one transaction on a direct access trading venue.[6]

- Dodd-Frank has brought about an overlap of dual regulation by two Federal agencies: the Federal Energy Regulatory Commission (FERC) and the CFTC, of certain physical commodity transactions[7] - namely "options" that – when entered into are intended to physically-settle, and when exercised, are fulfilled by one party delivering a physical commodity to the other party. Electricity is a unique commodity within CFTC's jurisdiction in that it's <u>not</u> a storable commodity, and yet it's still a physical or "nonfinancial" commodity. Using nonfinancial energy commodity options is essential for electric utilities, given volatile temperatures and consumption patterns in various US regions, the public utility responsibilities for providing reliable electric service in real-time, and the inability to store the commodity. Energy companies don't all trek to Wall Street dealers to meet our local needs. We transact end-user to end-user in regional markets for customized commercial hedges. Consequently, it is our energy markets that are most burdened by CFTC's jurisdictional reach – or overreach – to regulate nonfinancial commodity options where the parties intend physical settlement or delivery.

- Furthermore, it's commonplace in the energy markets to have transactions that combine both jurisdictional and non-jurisdictional attributes together. For example, fixed-volume forward contracts for one energy commodity will often include a layer of volume flexibility, called "embedded optionality" in the same commodity [or a related commodity such as emissions credits or generation capacity] in order to enable a commercial end-user to balance non-storable supply with variable demand in real-time. In 2012, CFTC adopted a complex set of interpretations to determine whether or not such hybrid transactions are jurisdictional as "swaps," in the form of a 7-part test.[8] So if you can thread all 7 needles with a single strand, your hybrid transaction is non-jurisdictional (not a "swap," just a plain old commercial forward contract). But the last needle – the notorious "seventh element" – is a miniature, and extra challenging to thread. More recently, CFTC has proposed to increase the size of the last needle with additional interpretive language.[9] Today, commercial end-users navigate a tangled web of rules, interpretation and guidance, and have debates with each other about whether certain nonfinancial energy transactions between them are subject to an overlap of dual Federal regulation. Many times, the counterparties in a transaction interpret the regulations differently, can't agree, and don't report consistently to CFTC. Each one must assess whose interpretation is right or wrong, whose

reporting is false vs. accurate, and one party or the other could potentially incur significant Commodity Exchange Act liabilities.

- Finally, CFTC's 2013 proposed rule for speculative position limits places more unnecessary burdens on commercial end-users of nonfinancial energy commodities and related swaps.[10] Very narrow "bona fide hedge exemptions" to position limits (that the CFTC believes must be universally applicable to traders and hedgers in all agricultural, oil, natural gas and other physical commodity derivative markets) are proposed by CFTC. Commercial end-users in these very different industries are being told they can only hedge their commercial risks using hedges that are also "bona fide" for traders. They are all viewed as potential market speculators in having to:
    - Monitor their "positions" in a specific commodity on a daily and intra-day basis[11];
    - Provide precise plans in 10-day notices to CFTC before hedge positions can exceed rigidly-set speculative position limits[12]; and
    - Submit reports to CFTC daily and monthly when positions, even aggregated across multiple utility subsidiaries in a consolidated group of commercial companies, exceed such limits[13].

The Commodity Exchange Act clearly permits a more broad and practical exemption from the whole speculative position limits regime for pure hedging

entities that do no speculating, or investing, and CFTC should exercise such broad exemptive authority.[14] For example, the commercial end-user exemption from swap clearing and trading venues adopted by CFTC three years ago could be used as a basis for exempting hedgers or hedging transactions from position limits. That standard is a far less onerous approach for providing hedging relief to commercial end-users, and should also be used by CFTC for position limits.

On the bright side, I commend the CFTC's willingness during the past 11 months to listen to commercial end-users concerns and to start taking account of the need for some changes as we approach the five-year anniversary of Dodd-Frank. I also commend the CFTC for resurrecting the Energy and Environmental Markets Advisory Committee after a five-year hiatus. The energy markets that the not-for-profit Electric Entity (co-op and municipal) members participate in are not just financial trading markets – they are regional markets our Members use to hedge the commercial risks of providing 24/7/365 electric service to their customer/members.

Moving forward, we would like Congress and the CFTC to address the challenges discussed in this testimony, whether legislatively or administratively, to ensure that commercial end-users are not treated like they were the cause of

the 2008 financial crisis. We look forward to providing any information that would be helpful to the Committee as it addresses CFTC reauthorization. We are supportive of reauthorization, but must respectfully request that the CFTC narrow the scope of its rules to remove the significant and unnecessary burdens on commercial end-users.

Thank you for the opportunity to testify. I'd be happy to answer any questions you may have.

---

[1] Commodity Options, 77 FR 25320 (Apr. 27, 2012).

[2] Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 FR n. 370, 48298, 48300, and n. 1160 (Aug. 13, 2012).

[3] *E.g. Id.* Commodity Options; CFTC Letter No. 13-08, *Staff No-Action Relief from the Reporting Requirements of § 32.3(b)(1) of the Commission's Regulations, and Certain Recordkeeping Requirements of § 32.3(b), for End Users Eligible for the Trade Option Exemption* (April 5, 2013), available at http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-08.pdf

[4] Adaptation of Regulations to Incorporate Swaps, 77 FR 66316 (Nov. 2, 2012) (noting 17 C.F.R. 1.3(q)(1)(ii)).

[5] 17 C.F.R. 1.35(a).

[6] 17 C.F.R. 1.35(a)(1) and 1.3(yy).

[7] *Id.* Commodity Options at 25325.

[8] *Id.* Further Definition at 48238.

[9] Forward Contracts With Embedded Volumetric Optionality, 79 FR 69073 (proposed Nov. 20, 2014) (Proposal).

[10] Position Limits for Derivatives, 78 FR 75680 (proposed Dec. 12, 2013) (Proposal).

[11] *Id.* at 75768.

[12] *Id.* at 75831-32 (noting § 150.7(d), (e), and (f)).

[13] *Id.* at 75789-90 (noting § 19.01(a)(1) and § 19.01(b)(2)(i)); at 75832 (noting § 150.7(g)).

[14] CEA section 4a(a)(7); 7 U.S.C. 6a(a)(7).