Testimony of the Honorable Glenn English, CEO
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Before the
United States Senate
Committee on Agriculture

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It is an honor to appear before the Senate Agriculture Committee again, and I thank you for this opportunity to share rural electric co-ops' perspective on the issue of derivatives regulation.

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. I should also note that for the states represented by the Senators on this committee alone, NRECA has 21.6 million members and 494 electric co-ops. I know that this committee cares deeply about the fate of rural America, and before discussing derivatives, I want to thank you for your strong support of the idea that someone's standard of living should not be dictated by his or her zip code.

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%.

Madam Chairman, the issue of derivatives and how they should be regulated is something with which I have a bit of personal history going back twenty years when I was a Member of Congress on the House Agriculture Committee. Accordingly, I am grateful for your leadership in pursuing the reforms necessary to increase transparency and prevent manipulation in this marketplace. From the viewpoint of the rural electric cooperatives, the proposals to regulate the $600 trillion over-the-counter (OTC) derivatives market can be boiled down to a single, simple concern: affordability.

NRECA's electric cooperative members, primarily generation and transmission members need predictability in the purchase price for their inputs if they are to provide stable, affordable prices to their customers. Rural electric cooperatives use derivatives to keep costs down by reducing the risks associated with both volatile energy prices and financial transaction costs. It is important to understand that electric co-ops are engaged in activities that are pure hedging, or risk management. Our consumers expect us, on their behalf, to protect them against volatility in the energy markets that can jeopardize small businesses and adversely impact the family budget. The families and small businesses we serve do not have a professional energy manager. Electric co-ops perform that role for them and should be able to do so in an affordable way. We DO NOT use derivatives for other purposes.

Most of our hedges are bilateral trades on the OTC market. Many of these trades are made through a risk management provider called the Alliance for Cooperative Energy Services Power Marketing or ACES Power Marketing, which was founded a decade ago by many of the electric co-ops that still own this business today. If a derivatives counterparty does not pay up, there will be severe consequences for our members, so we are extremely careful about who we trade with and for how much, which is why ACES Power Marketing makes sure that the counterparty taking the other side of a hedge is financially strong and secure.

Though most of our trading involves natural gas, derivatives, specifically interest rate and currency swaps, are an important asset/liability management tool for cooperative lenders as well. Half of the electric cooperatives' finance needs are met by private cooperative lenders, including the National Rural Utilities Cooperative Finance Corporation (CFC), which uses derivatives to manage currency and interest rate risk, and thereby affords our electric cooperative borrowers more loan options. Again, these products are NOT used for investment but for risk management.

Even though the financial stakes are serious for us, rural electric co-ops are not large participants in the derivatives markets. In a market estimated to be $600 trillion dollars, our members represent a tiny fraction of the market and are simply looking for an affordable way to hedge. While our small size makes us insignificant to the larger market, it does mean that legislative changes which dramatically increase the cost of hedging or prevent us from hedging all-together will impose a real burden.

I want to remind you that we are NOT looking to hedge in an unregulated market. NRECA DOES want derivatives markets to be transparent and free of manipulation. The problem is that requiring all derivatives contracts to clear is just not affordable for most co-ops. That is because the margin we would have to provide would make hedging untenable for many of our members – we would have to come up with hundreds-of-millions of dollars in cash that we just do not have on hand.

In general, co-ops are capital constrained due to their non-profit status and other capital demands, such as building new generation and transmission infrastructure to meet load growth, installing equipment to comply with clean air standards, and maintaining fuel supply inventories. As member-owned cooperatives, we cannot go to the equity markets for additional resources. Maintaining 42% of the nation's electrical distribution lines requires considerable and continuous investment. A cash margin requirement associated with clearing our trades could compromise our ability to meet that infrastructure need.

Clearing also presents a significant potential predictability issue. In case of a catastrophic event, the marketplace could change dramatically in a very short timeframe. If a catastrophic event triggered market concern over fuel supplies, ratings could shift and the prices for contracts could swing dramatically, triggering a sizable margin call for a reason unrelated to the original trade. A co-op in that position would not have the cash reserves to cover the margin call, leaving only one, unattractive option –to borrow a large sum at unaffordable rates.

Rural electric cooperatives do trade on exchange (and thus have some trades cleared) when we can. Electric cooperatives customarily have a couple thousand trades at any given time on NYMEX, but due to the working margin requirements associated with clearing and the highly specialized nature of others, most of our trades are made on the OTC market. We would like to be able to trade our standardized contracts on an exchange or go through a clearinghouse, but many of our members just cannot afford it.

With affordability in mind, NRECA has closely examined the legislative proposals produced by the Department of the Treasury, the House Committee on Financial Services, the House Committee on Agriculture, and the Senate Committee on Banking Chairman Christopher Dodd (D-CT). With regard to the requirements that OTC derivative contracts clear, and that there be capital and margin requirements for derivatives contracts, there is recognition in the Treasury, House Financial Services, and House Agriculture proposals that trades made by hedgers should be treated differently. As requested by the Chairman, I have limited my remarks on these proposal to the specific issue of clearing and margin requirements, and I would gladly discuss other issues on request.

The Treasury proposal includes both a clearing requirement for standardized trades and separate capital and margin requirements for trades that are not cleared. Exceptions to these requirements are provided, but our co-ops would have difficulty meeting these requirements because the hedge exemption in the definition of major swap participant, which is key to the clearing and capital and margin requirement exemptions, is subject to being "an effective hedge under generally accepted accounting principles (GAAP)." This requirement is problematic because, for starters, the outcome of "GAAP hedge effectiveness" is often unknown at the inception of a derivative hedge when a co-op would have to decide whether or not it would fit in the hedge exemption. Meanwhile, as most of our trades are for natural gas, and are largely standardized, it's unlikely we would meet the clearing exemption standard that, "no derivatives clearing organization registered under the Act will accept the swap for clearing." NRECA has recommended changes to the Treasury proposal that would improve upon this hedge exemption (see Appendix).

In both the House Committee on Financial Services and the House Committee on Agriculture proposals, the definition of major swap participant is, like in the Treasury proposal, a critical test for determining an exemption to the clearing requirement, as well as additional capital and margin requirements. Neither bill utilizes the problematic GAAP standard for hedging, but both pieces of legislation specifically recognize that those, like NRECA, who are using swaps for legitimate hedging activities do not qualify as major swap participants. Importantly, not only would these bills allow co-ops to continue to hedge on the OTC market, but they would also permit us to trade with counterparties who may be major swap participants – this is critical to the continued existence of liquid and functioning OTC markets for us to trade in.

Finally, Senate Banking Committee Chairman Dodd recently introduced a discussion draft proposal that included new regulations for derivatives. Unfortunately, this draft, unlike the other proposals, does not specifically exclude hedgers from its major swap participant definition. Moreover, even if it did include a workable hedge exclusion from that definition we are troubled that, as we saw in the Treasury proposal, GAAP standards are once again problematically used to define hedging, while this draft's clearing exemption provides no certainty to our members because it requires the CFTC to first issue an order or rule granting deeming it "necessary or appropriate in the public interest" to exempt the swap transaction from clearing. Also adding to the uncertainty, the CFTC may grant a clearing exemption when one counterparty is not a swap dealer or major swap participant only if such party also does not meet the eligibility requirements of any dealers clearing organization for swaps. We simply must have more certainty for our members' legitimate hedge transactions.

Madam Chairman, we are looking for a legitimate, transparent, predictable, and affordable device with which to hedge. I know there are many ideas under consideration, but regardless of what specific solution is arrived at, I know that you and your committee are working hard to ensure these markets function effectively. The rural electric co-ops just hope that at the end of the day, there is a way for the little guy to affordably manage risk.

Thank you.