Testimony of Joseph R. Glace
Vice President and Chief Risk Officer, Exelon Corporation
Before the Committee on Agriculture, Nutrition, and Forestry
United States Senate
September 9, 2009

Mr. Chairman and Members of the Committee:

My name is Joe Glace, Vice President and Chief Risk Officer of Exelon Corporation. Exelon is a public utility holding company headquartered in Chicago. Our local retail distribution utilities, ComEd, which serves northern Illinois including the city of Chicago, and PECO Energy, which serves southeastern Pennsylvania including the city of Philadelphia, together serve 5.4 million customers, or about 12 million people – more than any other company in the United States. We have fossil, hydro, nuclear and renewable generation facilities. Our nuclear fleet is the largest in the nation and the third largest in the world. I have worked in the energy field for 29 years. At Exelon, I am responsible for leading our risk management function, including the identification, assessment and monitoring of market, credit, and operational risks.

In my testimony today I want to highlight Exelon's:

- Support for comprehensive climate legislation;
- Opposition to requiring all trading, derivatives, and hedging activities to be conducted on exchanges;
- Support for expanding the CFTC's jurisdiction to the new market for carbon allowances, including the over-the-counter (OTC) market; and
- Support for reporting requirements for OTC transactions in the carbon markets

Exelon was an early and vocal advocate of climate change legislation. We have testified in favor of passage on several occasions. Our CEO, John W. Rowe, first testified in favor of addressing climate change by means of a carbon tax in 1992. We are pleased that the House has passed a comprehensive climate and energy bill and look forward to working with this Committee and the Senate to pass comprehensive, cap-and-trade legislation this year.

Exelon supports an economy-wide bill with realistic targets and timetables, an effective cost containment mechanism, such as a cost collar, and allocating electric sector allowances to regulated local electric utilities with a requirement that the value represented by the allowances is used to provide benefits to customers.

To better understand Exelon's views regarding regulation of the carbon market and the concerns that are the intended focus of this hearing, I think it is important to explain briefly Exelon's overall approach to commodities trading. We are not speculators. We use commodities trading to reduce the price risk we face as an electric generation company. That is, our primary objective is to reduce the risk to our revenues that we would face if we were completely subject to the sometimes sharp fluctuations in short-term, spot market power prices.

Let me delve into this a bit further. A substantial majority of our generation fleet is located in the geographic footprint of what are known as "regional transmission organizations" or RTOs. RTOs are regulated by the Federal Energy Regulatory Commission or FERC. RTOs operate competitive markets for wholesale energy and capacity. Accordingly, unless Exelon does something about it, Exelon is completely exposed to the ups and downs of the short-term, spot market energy prices in those markets. That is, we could make a lot of money if the spot prices turn out to be high, or lose a lot of money if they turn out to be low. Because we are not speculators, however, we are not willing to take that gamble. Instead, our business model is to lock in, or hedge, the price we are paid for the electricity we generate.

We do this by buying and selling energy products that are available in the commodities markets. For example, we might sell an amount of electricity for one agreed price for all hours in the summer months of June through September. We will then know that we will always get that price for that amount of electricity during those four months. We forego the prospect of getting higher prices absent the sale, but, and more importantly, we avoid the risk that prices will fall below the fixed price we are paid by the buyer of the electricity. We also can do the same thing with respect to the fuel we buy to run our plants. We might transact in the OTC market for coal to lock in our fuel cost for our coal plants.

An increasingly large percentage of our hedging transactional activity is in the markets for purely financially-settled swaps and options, or derivatives, where the underlying reference commodity is usually electricity, natural gas, oil, or coal. For example, we might enter into a swap pursuant to which a counterparty pays us $25 per megawatt for 50 megawatts of electricity per hour for every hour in the month of July, and we pay the counterparty the spot market price that we are paid by the RTO for the electricity we have actually generated. The result for us is that we are guaranteed that we will be paid $25 per megawatt of electricity – no more and no less. The counterparty makes money if the spot prices we pay it turn out to be higher than $25 per MW, and loses money if the spot prices are lower than $25 per MW. No physical electricity actually changes hands; rather, only an exchange of revenue streams happens, based on an underlying variable commodity price (the spot market price of power). Exelon gets a fixed revenue stream and the counterparty gets, and takes the risk associated with, a variable revenue stream determined by the spot market price of power – a risk that Exelon would otherwise take but for the transaction.

Our customers benefit from this hedging and trading activity. We are in a position to agree to longer term power sales contracts with both wholesale and retail customers; the price terms under those contracts are in large part possible because of the relative price stability hedging provides to our portfolio. It is our experience that retail customers in particular want prices for power sales to be stable rather than subject to the fluctuations of the spot market. Without hedging and trading we simply would not be able to do that.

One of the principal concerns many have expressed with adopting a carbon control regime is how it will affect our fragile economy. We at Exelon believe that the economic impact of a comprehensive program will be manageable if the legislation includes the elements outlined above and if it provides the mechanisms necessary for a robust allowance trading program, including derivative products derived from those allowances. Simply put, a properly regulated, robust trading program, plus liquid trading markets, will help control the overall cost of the program. That is why it is important to view the issues before this Committee, which are the topic of today's hearing, from the customer's perspective. What steps should the Congress take to effectively regulate and ensure the integrity of carbon trading markets without imposing undue costs on consumers?

Our strongly held view is that any regulatory reform of the commodities markets should ensure that the products which we use to prudently hedge our business risks remain available to us and at a cost that is comparable to the costs we face today. This means that we believe it would be a mistake to force most, if not all, derivative hedging transactions like the ones I just described to exchange-traded platforms such as the New York Mercantile Exchange (NYMEX), or to require that all bilateral or OTC derivative transactions be cleared through exchanges like the NYMEX. We enter into futures contracts on the NYMEX, and also clear some transactions with NYMEX and other clearing platforms, but a substantial component of our derivatives hedging program is in the OTC market without clearing.

Transacting on exchanges is much more expensive than in the OTC markets because it requires posting of substantial amounts of cash as collateral. This is one reason we do not – in fact cannot – conduct all of our hedging activity on exchanges. The OTC market enables us to transact with creditworthy counterparties without having to post potentially huge amounts of cash collateral but also without taking on any materially greater amount of default risk. We can more efficiently husband our cash by using other forms of payment security and collateral to secure some of our risks bilaterally in the OTC markets, including letters of credit, payment guarantees, and pre-payment arrangements. Were we to have to move all of our hedging to exchanges, any move in price could require additional cash outlays in the hundreds of millions of dollars range, and possibly even in the billions. This, in turn, would mean that we would have to charge substantially more for our product – electricity – which means our customers would have to pay substantially more for this vital commodity.

The same is true, albeit indirectly, of any requirement to clear OTC derivatives. Counterparties will be loathe to clear materially larger volumes than they do currently, because once cleared, their counterparty becomes the exchange, and the more costly posting requirements applicable to exchange-traded transactions would then kick in.

Another drawback of limiting hedging activity to exchanges and clearing platforms is that these entities will only offer futures for, or provide a clearing platform for, a standardized set of products. Exelon enters into customized transactions that get us a lot closer to completely eliminating the particular price risk we are trying to hedge than would one of the standard products that would regularly trade on exchanges.[1]

To draw the obvious conclusion – power prices will be higher, meaning that consumers will ultimately pay more than they would otherwise, if companies like Exelon are forced to do all of their hedging on exchanges and clearing platforms.

Exelon is not alone in its opposition to requiring all transactions to go through exchanges. I want to draw your attention to a recent letter sent to all senators by a large group of trade associations representing the energy sector, rural electric cooperatives, and consumer groups, a copy of which is attached to this testimony. It raises the same concerns about the increased costs of dealing primarily through exchanges and clearing platforms that I have explained, and therefore shows that there is a broad consensus among energy suppliers and consumer associations that forced exchange trading and mandatory clearing is not the way we should address the concerns that this committee is tackling.

[1] As noted in a recent briefing paper published by the Pew Economic Policy Department, "[e]conomic efficiency is harmed if those with commercial needs for hedging are forced entirely into standard derivatives positions that are relatively poor hedges, or if derivatives markets are unable to innovate along with changes in the economy." Darrell Duffie Dean Witter Distinguished Professor of Finance at Stanford University's Graduate School of Business, (2009), "How should we regulate derivatives markets?," Pew Briefing Paper # 5, Pew Economic Policy Department, p. 18. See http://www.pewfr.org/admin/task_force_reports/files/Pew_Duffie_Derivatives.pdf

Exelon believes there are better ways to protect commodity markets from the risk that some entities may try to manipulate them, and from the more fundamentally systemic risk that the country faced as a result of the unregulated and frenzied speculative trading that went on in the credit default swap markets. To explain what we think would make the most sense, I now turn to the question at hand – what to do about the coming market for carbon emissions allowances.

The carbon cap and trade proposal that Exelon supports, and that is contemplated in the legislation passed by the House, will immediately result in a large, new market for carbon allowances. One of the critical electricity consumer-protection features of the House-passed bill is the provision that would require allocation of 30% of the allowances - which recipients would receive at no cost - to regulated local distribution utilities. This proposal has very broad support, ranging from investor-owned utilities, electric cooperatives, and municipals, to state regulators and consumer advocates. The local distribution utilities are not "covered entities," to borrow a term of art from the House bill; that means they will have no compliance obligation, and therefore will not "need" the allowances they receive for compliance purposes. The utilities, however, would be required to ensure that the benefit of those allowances goes to their customers. Every state, and the District of Columbia, has a public utility commission, or PUC. The PUCs regulate the local utilities and have authority to ensure that the customers do, indeed, benefit from the allowances. In the case of Exelon, our distribution utilities, PECO and Com Ed, will sell the allowances, and then the Pennsylvania and Illinois PUCs will oversee the use of the proceeds to ensure that they will benefit customers. One way they will consider to accomplish this result will be to use the revenues to reduce customer rates. They could also require the revenues to be used for financial assistance to customers who need it or energy efficiency programs.

Generation-owning entities like Exelon, as well as other emitters, will need to procure allowances to comply with carbon emissions caps; we and other generators will be covered entities. In this regime, the cost of carbon allowances will be a cost of doing business for generators. It will be just like the cost of gas, oil, or coal – 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. That will mean that Exelon will want to have as wide a range of options as it currently does 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 appropriate market levels.

That is why we support the expansion of the CFTC's jurisdiction to the new market for carbon allowances, including the OTC market that will certainly develop. This 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 OTC markets, and perhaps revised and refined to ensure that they provide to the CFTC the tools it needs to prevent manipulation.

For the same reason, Exelon also supports the adoption of new reporting requirements for OTC transactions in the market for carbon allowances. The CFTC has to have access to information about transactions to enable it to fulfill its regulatory oversight and enforcement function. Also, the obligation to report, as such, will be a powerful deterrent to would-be manipulators.

In addition, Exelon appreciates the critical nature of the country's need to prevent, for all time, the kind of crisis we faced last year, which revealed to all that unbridled trading activity could pose potentially catastrophic systemic risk. Accordingly, in addition to comprehensive transaction reporting requirements, Exelon supports the development and establishment of rules and guidelines that the CFTC would use to "stress test" the riskiness of the portfolios of major swap dealers and participants active in the carbon markets, and in particular of those whose primary business, unlike Exelon's, is to make markets and trade derivatives for their own account.

I appreciate the Committee's invitation to testify today. You are dealing with an extraordinarily complicated subject area. I hope that I have provided you with a sense of why it is important to ensure that there is effective oversight of the emerging carbon markets while at the same time guarding against over-regulation that would result in higher costs for companies like Exelon and in turn for our customers. I would be pleased to answer any questions you may have.

Joint Association Letter Regarding the OTC Derivatives Issue

July 10, 2009

Dear Senator:

The undersigned energy supplier and consumer associations represent all the major segments of the electric power and natural gas industries serving virtually all of the consumers in the United States. We are writing to express our concern with certain aspects of proposals to address oversight and transparency of over-the-counter (OTC) energy markets. While we support the goals of the Administration and the Congress to improve transparency and stability in OTC derivatives markets and to prevent excessive speculation, it is essential that policy makers preserve the ability of companies to access critical OTC energy derivatives products and OTC energy commodities markets. We rely on these products and markets to manage risks to help stabilize and keep energy costs low for consumers.

The members of the associations represented on this letter use the OTC markets to hedge a variety of risks associated with energy production and fuel costs. We use OTC contracts to help insulate our business and customers from excessive price volatility.

Specifically, we are concerned with proposals to impose mandatory clearing of all OTC transactions, as well as requirements to force OTC derivative transactions to be moved onto an exchange. We believe that such proposals would significantly increase costs for companies seeking to hedge risks through OTC products, as well as greatly limit, or eliminate altogether, needed customized products used for risk management for the following reasons:

- The high cash margin requirements of a clearinghouse or an exchange would significantly increase transaction costs, and tie up needed cash at a time when the cost of capital is high, access to capital markets is uncertain, and our industries need to invest billions in new energy infrastructure.

- At the same time, since clearinghouses and exchanges require a high level of standardization and liquidity in the derivatives and commodities products traded, we believe that such proposals would greatly reduce the ability of companies to find the customized derivative products they need to manage their risks. For example, in the case of electricity, the prerequisites for standardized and centralized clearing are missing, since its unique physical nature precludes significant storage and requires that it be consumed when generated in hundreds of physical markets.

Ultimately these increased costs and risks will be borne by all consumers. We believe that there are far better ways to accomplish the goals of greater transparency and effective regulatory oversight of OTC energy derivatives and commodities markets without mandatory clearing or forcing these products to be moved onto an exchange. We would welcome the opportunity to discuss these issues with you.

<u>List of supporting associations:</u>

American Gas Association
America's Natural Gas Alliance
American Exploration & Production Council
American Public Gas Association
American Public Power Association
Edison Electric Institute
Electric Power Supply Association
Independent Petroleum Association of America
Interstate Natural Gas Association of America
Large Public Power Council
National Association of Manufacturers
Natural Gas Supply Association
National Rural Electric Cooperative Association
US Chamber of Commerce
US Oil & Gas Association