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before the

SENATE COMMITTEE ON AGRICULTURE, NUTRITION and FORESTRY

HEARING on

REAUTHORIZATION of the COMMODITY FUTURES TRADING COMMISSION

July 17, 2013

Chairwoman Stabenow, Ranking Member Cochran, and Members of the Committee, thank you for the opportunity to speak today on the reauthorization of the Commodity Futures Trading Commission (CFTC). I am Donald Russak, Executive Vice President and Chief Financial Officer for the New York Power Authority (NYPA), testifying on behalf of my utility, the state of New York, and the American Public Power Association (APPA).

NYPA is America's largest state power organization, with 16 generating facilities, and more than 1,400 circuit miles of high-voltage transmission lines. Our customers include: 115 government entities in New York City metropolitan area, including the City of New York, the Metropolitan Transportation Authority, the Port Authority of New York and New Jersey, the New York City Housing Authority, the County of Westchester and most Westchester municipalities, school districts and other public entities; 47 municipal electric systems and four electric rural cooperatives; numerous non-profit health-care, educational and cultural institutions within New York including museums, colleges and universities, and hospitals; and, public agencies in seven neighboring states—Connecticut, Massachusetts New Jersey, Ohio, Pennsylvania, Rhode Island, and Vermont. In addition, our low cost power is sold to businesses and industries in New York State which support and sustain more than 380,000 jobs.

NYPA and the municipal utilities it serves are members of APPA, the national service organization representing the interests of over 2,000 municipal and other state- and locally-owned, not-for-profit electric utilities throughout the United States (all but Hawaii). Collectively, these "public power" utilities [1] deliver electricity to one of every seven electricity customers in

[1] "Public power" is not defined in the law, but generally refers to government-owned utilities. This is distinguished from a "public utility" which generally refers to an investor-owned utility, as under the Public Utility Holding Company Act of 1935 and the Federal Power Act.

the United States (approximately 47 million people). APPA member utilities serve some of the nation's largest cities, but the vast majority serve communities with populations of 10,000 people or less.

I appear today to ask the Committee in reauthorizing the CFTC to include legislation that will allow my utility, and other public power and public natural gas utilities, to hedge against price risks on a level playing field with that of other utilities. Such legislation should provide the broadest market for us to hedge these risks, allowing us to better match hedging transactions to power and fuel price risks, and, so, protect all our customers from unnecessary price volatility. We believe that H.R. 1038, the Public Power Risk Management Act of 2013, would achieve this goal. The House approved H.R. 1038 with a 423-0 vote in June. We would hope that this Committee, and the Senate, would take up and approve this narrowly-crafted, widely-supported bill, but welcome any vehicle—including further action by the CFTC—that will effectively and expeditiously resolve our concerns.

Public Power Utilities and the Dodd-Frank Act

In the wake of the 2007 and 2008 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) required the CFTC to provide comprehensive regulations for the swaps marketplace. Specifically, the Dodd-Frank Act requires greater reporting of swaps, allows the CFTC to require mandatory clearing for certain types of transactions, and requires swap dealers and major swap participants to register with the CFTC and meet capital, margin, and reporting and recordkeeping requirements, as well as to comply with rigorous business conduct and documentation standards. To address concerns that the legislation would force too many entities into the more stringent swap dealer regime, the Dodd-Frank Act included a "*de minimis* exception" to the definition of a swap dealer.[2]

Additionally, the Dodd-Frank Act provides more rigorous standards for a swap dealer or major swap participant advising or entering into a swap with a "special entity." As defined under the Dodd-Frank Act, a special entity is any public power or natural gas utility, any other government entity, a charitable organization or a pension plan.[3] For a swap dealer acting as an advisor to a special entity, the law states that the swap dealer has a duty to act in the best interest of the special entity.[4] A swap dealer or major swap participant entering into a swap with a special entity must have reason to believe that the special entity has a qualified independent representative.[5]

[2] 7 USC § 1a(49)(D); Letter from S. Comm. on Banking, Hous. & Urban Affairs Chairman Christopher Dodd and S. on Agric., Nutrition, & Forestry Chairman Blanche Lincoln to H. Comm. on Fin. Serv. Chairman Barney Frank and H. Comm. on Agric. Chairman Collin Peterson (June 30, 2010)(stating that "Congress incorporated a de minimis exception to the Swap Dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation.").
[3] 7 USC § 6s(h)(2)(C).
[4] 7 USC § 6s(h)(4).
[5] 7 USC § 6s(h)(5).

We believe the Dodd-Frank Act will provide needed transparency and certainty to swaps markets and support providing the resources necessary to the CFTC to fulfill its obligations under the Commodity Exchange Act, including implementation of the Dodd-Frank Act.[6] APPA and other interested parties have worked closely with the CFTC to improve implementation of the Dodd-Frank Act, particularly related to regulations affecting "end users"—that is, nonfinancial parties that enter into swaps to hedge or mitigate their commercial risks. NYPA and other APPA members are "end users." Dozens of new regulations affect public power utilities, and APPA and a coalition of not-for-profit electric utilities have submitted formal comments on 17 specific regulations proposed by the CFTC and Securities and Exchange Commission (SEC) as part of their implementation of the Dodd-Frank Act. One such instance is the rule defining "swap dealer."[7]

In December 2010, the CFTC jointly with the SEC issued a proposed rule to define the term "swap dealer," including (as discussed above) an exception from the swap-dealer designation for those entities that engage in a *de minimis* quantity of swap dealing. In the proposed rule, the CFTC proposed two separate *de minimis* thresholds relating to the dollar quantity of swaps: $100 million annually for an entity's total swap-dealing activity; and, $25 million annually for an entity's swap-dealing activity with special entities, including, as noted above, public power, public gas, and federal utilities.

In February 2011, the Not-For-Profit Electric End User Group (NFP EEU)—which includes APPA—filed comments on the proposed swap dealer rule. The comments recommended that the CFTC substantially increase the *de minimis* threshold both for total swaps and for swaps with special entities.

A final swap dealer rule was approved by the CFTC on April 18, 2012, and was published in the *Federal Register* on May 23, 2012. The final rule greatly increased the overall *de minimis* threshold from the proposed rule, raising it from $100 million to $8 billion temporarily, and $3 billion over time. But, the final rule did <u>not</u> change the proposed rule's $25 million sub-threshold for swap-dealing activities with special entities. Thus, the disparity between the two thresholds is now substantially greater. This $25 million sub-threshold is smaller still when you consider that it is the aggregate of a swap partner's transactions with <u>all</u> special entities during any 12-month period.[8]

The swap dealer rule became final on July 23, 2012. Swap dealer registration regulations went into effect on October 12, 2012, at which time entities were required to begin counting their "swap dealing" activities. Those with dealing activity in excess of the *de minimis* thresholds must register as swap dealers.

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[6] See, for example, Letter from Commodities Mkts. Oversight Coal. to the S. Subcomm. on Fin. Serv. (June 24, 2013)(co-signed by APPA and urging full-funding for the CFTC in Fiscal Year 2014 appropriations process).
[7] CFTC Regulation 1.3(ggg)(4); see 77 Fed. Reg. 30596, at 30744.
[8] By way of reference a single, one-year 100 MW swap could have a roughly $25 million notional value. One-hundred MWs of power is enough to serve the average demand of approximately 75,000 residential customers.

As a result, nonfinancial entities (such as natural gas producers, independent generators, and investor-owned utility companies) that do not want to be swap dealers have limited their swap-dealing activities with public power utilities to avoid exceeding the $25 million threshold. This greatly hinders public power utilities' ability to hedge against operational risks. Just like NYPA, these utilities have no shareholders, so the costs imposed by this regulatory decision will be borne by only one group: public power customers.

Why Hedging Is Necessary

Public power utilities depend on nonfinancial commodity transactions, trade options, and "swaps," as well as the futures markets, to hedge commercial risks that arise from their utility facilities, operations, and public service obligations. Together, nonfinancial commodity markets play a central role in the ability of public power utilities to secure electric energy and fuel for generation at reasonable and stable prices.

Specifically, many public power utilities purchase firm electric energy, fuel and natural gas supplies in the physical delivery markets (in the "cash" or "spot" or "forward" markets) at prevailing and fluctuating market prices, and enter into bilateral, financially-settled nonfinancial commodity swaps with customized terms to hedge the unique operational risks to which many public power utilities are subject. Additionally, many public power utilities have used the swaps and futures products to hedge their excess electric generation capacity, thus providing revenue and rate certainty to their customer/owners. In hedging, mitigating or managing the commercial risks of their utility facilities' operations or public service obligations, public power utilities are engaged in commercial risk management activities that are no different from the operations-related hedging of a private, for-profit, investor-owned utility or a non-profit, private electric cooperative.

Why Nonfinancial Counterparties Are Necessary

Electric power touches virtually every home and business in the United States. This near universality gives a false appearance of homogeneity. It is important to remember that what is being delivered, either power or fuel to provide power, is a physical commodity, e.g., electricity, coal, and natural gas. Ownership of a stock can be transferred coast to coast with a click of a button, but electricity must be delivered to the place it is to be used. Further, storage of electricity for future use, unlike other commodities such as gasoline, grain, or coffee, is not currently viable on a large scale and thus electricity must be produced at the time it is used.

Each regional geographic market has a somewhat different set of demands driven by climate, weather, population, and industrial activity, among other factors. Each regional geographic market also has a somewhat different group of financial entity counterparties and nonfinancial entity counterparties available to meet these demands and thus able to enter into utility operations-related swaps needed for hedging price and supply risks. For example, a large merchant electric generation station in western Alabama might be available as a nonfinancial counterparty for a swap transaction to provide electricity to a specific site in Alabama. But that same entity would not necessarily be able to offer the electricity in Oregon, and so would not be able to help an Oregon-based utility hedge its risks. Further, owners of electric generation

facilities and distribution utilities operate in their geographical proximity. This is true whether they are investor-owned utilities, cooperative utilities, merchant generation companies, or public power utilities, and they are the most likely trading counterparties in their regions. These regional market participants, unlike financial entities, have a vested interest in maintaining the reliability of the grid and ensuring that sufficient liquidity exists to manage their operations.

In Regional Transmission Organization (RTO) markets such as the Pennsylvania-New Jersey-Maryland Interconnection (PJM) and the New York Independent System Operator (NYISO), the market design is such that using financial swaps and futures contracts to manage risk is now the standard. This is because the RTO markets provide unlimited physical liquidity in the day-ahead and real-time markets to ensure reliability of service. Thus, converting a financial price hedge to a physically delivered product in real-time is, by design, the way these RTO markets function.

Because there are a limited number of counterparties for any particular operations-related swap sought by a utility, each financial or nonfinancial swap counterparty brings important market liquidity and diversity: the greater the number of counterparties, the greater the price competition. Conversely, reduced price competition necessarily increases prices.

NYPA and the Special Entity Sub-Threshold

I would like to illustrate these points with examples from NYPA's perspective. NYPA was created to help provide a continuous and adequate supply of dependable electric power and energy to the people of the State of New York. The electric energy, generation-fuel and related products required or produced by NYPA and its customers are subject to the forces of unregulated, wholesale commodity markets. As such, the prices of these products are volatile and uncertain, in turn, exposing NYPA's financial position and its customers' rates to significant uncertainty, including price risk. NYPA uses hedging transactions to reduce its market risk, to stabilize revenue and, most importantly, to provide rate certainty to many of its customers, including nearly 2,000 megawatts of governmental customer load in the New York City metropolitan area and several hundred megawatts of business customer load statewide.

NYPA's approach to hedging has been to enter into agreements with the most active and experienced physical and financial counterparties with solid credit ratings. NYPA routinely seeks quotes from a number of potential counterparties before entering into a hedging transaction. As NYPA's transactions are conducted in a major Regional Transmission Organization market, NYPA relies primarily on financial swaps and futures contracts to manage its risk. Following the implementation of the special entity sub-threshold rule, several utility end users have refused to enter into financial hedging transactions with NYPA due to NYPA's status as a "special entity." These counterparties cite the compliance risk of exceeding the $25 million sub-threshold and the extensive recordkeeping and reporting responsibilities that would follow if they were deemed to be a "Swap Dealer" under CFTC regulations. As a result, the number of eligible counterparties willing to provide competitive quotes to NYPA has been reduced, which will naturally lead to increased costs being borne by our governmental and business customers, imperiling jobs and increasing taxes.

Public Power Utilities' Petition for Rulemaking

On July 12, 2012, APPA, the Large Public Power Council (LPPC), the American Public Gas Association (APGA), the Transmission Access Policy Study Group (TAPS), and the Bonneville Power Administration (BPA), filed with the CFTC a "Petition for Rulemaking to Amend CFTC Regulation 1.3(ggg)(4)." The petition requests that the CFTC amend its swap-dealer rule to exclude utility special entities' utility operations-related swap transactions from counting towards the special-entity threshold. This amendment to the swap-dealer rule would allow a producer, utility company, or other nonfinancial entity to enter into energy swaps with public power utilities without danger of being required to register as a "swap dealer" solely because of its dealings with public power utilities.

Specifically, the petition asks for a narrow exclusion:

- A public power (or natural gas) utility's swaps related to utility operations would not count towards the special entity *de minimis* threshold, but would count towards the total *de minimis* threshold.

- Utility operations-related swaps are those entered into to hedge commercial risks intrinsically related to the utility's electric or natural gas facilities or operations, or to the utility's supply of natural gas or electricity to other utility special entities, or to its public service obligations to deliver electric energy or natural gas service to utility customers. For example, these would include swap transactions related to the generation, production, purchase, sale, or transportation of electric energy or natural gas, or related to fuel supply of electric generating facilities.

- Utility operations-related swaps do not include interest rate swaps. Those swaps would remain subject to the $25 million special entity sub-threshold.

CFTC "No Action" Letter

CFTC released on October 12, 2012 a no-action letter from its Division of Swap Dealer and Intermediary Oversight (Division) relating to the $25 million special entity sub-threshold.[9] The letter states that the Division will "not recommend that the Commission commence an enforcement action" against a counterparty dealing in up to $800 million in swaps with public power utilities without registering as a swap dealer. As the Division explained in that letter, the $800 million is derived from a comment letter endorsed by the NFP EEU group suggesting that the special entity sub-threshold be set at 1/10th that of the overall swap dealer threshold.

The no-action letter was a result of hours of meetings with CFTC Commissioners and staff, who we believe made a good faith effort to resolve this issue in the midst of implementing a comprehensive reform of our nation's financial system. We also believe that input and inquiries

[9] Commodity Futures Trading Comm'n, No-Action Letter, Letter No. 12-18 (Oct. 12, 2012).

from lawmakers and staff, including from this Committee, provided assurances to the CFTC that such relief would be welcomed.

The no-action letter, however, has failed to resolve this issue, in part because it included a number of additional limitations on a counterparty wishing to take advantage of the relief provided by the letter. Specifically, under the terms of the CFTC's no-action letter, the $800 million threshold applies only:

- If the special entity that is a party to the swap is using the swap to hedge a "physical position;"

- If the counterparty is not a "financial entity" as defined in the Commodity Exchange Act;

- If the swap is related to an exempt commodity in which both parties transact as part of the "normal course of their physical energy businesses;" and

- If a counterparty wanting to take advantage of the relief provided by the no-action letter files with the CFTC a notice that it is making use of the relief and provides, by December 31 (and quarterly thereafter), a list of each utility special entity with which it has entered into swaps and the total gross notional value of those swaps.

Certain counterparties have expressed concerns over one or more of the conditions imposed in the no-action letter. We believe that counterparties also simply are not willing to spend the time and money to create a separate compliance process and adjust their policies and procedures in order to facilitate transactions with the small segment of any particular regional market that utility special entities represent. This is especially likely now as counterparties are focused on implementing compliance programs dealing with the whole range of Dodd-Frank requirements. Finally, there is the overarching issue that the no-action letter, by definition, is temporary and can be revised or revoked without any of the steps of a formal rulemaking process.

Whatever the reason, the no-action letter has failed to provide nonfinancial counterparties with the assurances they need to enter into swap transactions with NYPA or other APPA members.

A November 19, 2012, letter to the CFTC from APPA explaining this outcome and support from several CFTC commissioners for relief[10] have failed to produce further action from the CFTC. As a result, some CFTC commissioners and staff, while preferring to correct the sub-threshold issue through regulations, have said public power utilities should also, or instead, seek relief from Congress.

[10] Statement of Bart Chilton, Comm'r, Commodity Futures Trading Comm'n (April 3, 2013)(describing an "end-user bill of rights" including the right of "public power end users using swaps to hedge commercial risks (to) the same access to risk management markets as privately-owned utilities"); Scott O'Malia, Comm'r, Commodity Futures Trading Comm'n, Keynote Address to Energy Risk USA 2013 (May 14, 2013)(stating that "in trying to protect Special Entities from the perils of trading in the swaps market, we have forced them to trade with large Wall Street banks since no other entity is willing to trade with them for fear of becoming a swap dealer").

The Public Power Risk Management Act

On March 11, 2013, the Public Power Risk Management Act of 2013 (H.R. 1038) was introduced by Congressman Doug LaMalfa (R-CA), a member of the House Committee on Agriculture, with fellow committee members Jim Costa (D-CA), Jeff Denham (R-CA), and John Garamendi (D-CA), along with House Financial Services Committee member Blaine Luetkemeyer (R-MO).

The legislation was approved by a unanimous voice vote in the House Committee on Agriculture on March 20, 2013. It was taken up by the full House under suspension of the rules on June 12, 2013, and passed 423-0. After being sent to the Senate, the legislation was referred to this Committee for its consideration.

The legislation largely mirrors the intent and effect of the public power utility petition to the CFTC, providing narrowly targeted relief for operations-related swaps for public power utilities. Specifically, the legislation would provide that the CFTC, in making a determination to exempt a swap dealer under the *de minimis* exception, must treat a utility operations-related swap with a utility special entity the same as a utility operations-related swap with any entity that is not a special entity.

Under the current threshold/sub-threshold regulatory regime adopted by the CFTC, this would mean that utility operations-related swaps with a public power (or public natural gas) utility would not be counted in calculating whether swap dealing activity exceeded the $25 million special entity *de minimis* threshold, but would be counted in calculating whether swap dealing activity exceeded the $8 billion *de minimis* threshold. Certainly, that is the legislation's intent.[11]

The legislation carefully defines which entities would qualify as a "utility special entity." It also specifically defines the types of swaps that could and could not be considered a "utility operations-related swap." For example, the legislation specifically would prohibit an interest, credit, equity, or currency swap from being considered a utility operations-related swap. Likewise, except in relation to their use as a fuel, commodity swaps in metal, agricultural, crude oil, or gasoline would not qualify either. Finally, the legislation also confirms that utility operations-related swaps are fully subject to other swap reporting requirements created under the Dodd-Frank Act.

When implemented, this legislation should provide the certainty to a nonfinancial entity that it can enter into a swap transaction with a public power utility without fear of being deemed a swap dealer. It truly levels the playing field, and it does nothing to otherwise alter the CFTC's implementation of the Dodd-Frank Act.

We wish the legislation were not necessary, but given the realities we face and the ongoing damage being done under the current rules, we urgently request the members of this committee

[11] H.R. Rep. No. 113-107, at 1 (2013) (stating, "In effect, the counterparties of utility special entities would no be subject to the much higher $8 billion de minimis swap dealer registration threshold.").

to support this narrow legislative fix, either by advancing H.R. 1038 or by including similar relief in legislation reauthorizing the CFTC.

Conclusion

In conclusion, the protections the CFTC affords through the $25 million special entity sub-threshold are not needed for utility operations-related swaps entered into by public power utilities, which are well-versed in the markets in which they hedge price and operational risks. In fact, by driving non-financial counterparties away from entering swaps with public power utilities, the sub-threshold limits the number of market participants with whom public power utilities can hedge their risk. Ultimately, this will increase operational risks and hurt our customers.

As a result, we very much appreciate this Committee's longstanding interest in this issue. We will continue to work with this Committee, Congress, and the CFTC to craft an appropriate and narrow solution, such as the relief proposed in our petition before the CFTC or in H.R. 1038.

Thank you again for this opportunity to testify, and I would be more than happy to answer any questions you might have.