May 1, 2013

The Honorable Debbie Stabenow
Chairwoman
Committee on Agriculture, Nutrition and Forestry
United States Senate
Washington, D.C. 20510

The Honorable Thad Cochran
Ranking Member
Committee on Agriculture, Nutrition and Forestry
United States Senate
Washington, D.C. 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

As the Senate Agriculture Committee begins consideration of legislation to reauthorize the Commodity Futures Trading Commission, the American Public Power Association (APPA) and Large Public Power Council (LPPC) urge you to consider the effect of amendments made to the Commodity Exchange Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) on public power utilities.[1]

APPA is 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 deliver electricity to one of every seven electricity customers in the United States (approximately 47 million people), serving some of the nation's largest cities. However, the vast majority of APPA's members serve communities with populations of 10,000 people or less.

LPPC is the national service organization comprised of 26 of the nation's largest public power utilities. LPPC member utilities own and operate more than 86,000 megawatts of generation capacity and over 35,000 circuit miles of high voltage transmission lines. Together, LPPC members control 90% of the public-agency-owned, but non-federal, transmission investment in the nation.

<u>Public Power Utilities and the Dodd-Frank Act</u>

Passed by Congress in the wake of the 2007 and 2008 financial crisis, the Dodd-Frank Act required the Commodity Futures Trading Commission (CFTC) to provide comprehensive regulations for the swaps marketplace. Specifically, the Dodd-Frank Act 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.

The Dodd-Frank Act provides additional standards for swap dealers or major swap participants advising or entering into swaps with including public power utilities, and other government

[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.

entities (referred to under the statute as "special entities"). For a swap dealer acting as an advisor to a special entity, the law states that the swap dealer shall have a duty to act in the best interests of the special entity.[2] For swap dealers or major swap participants entering into swaps with special entities, the law states that these dealers and swap participants must comply with rules set by the CFTC, requiring special entities to have a qualified independent representative before trading with a swap dealer or major swap participant.[3]

Also, in part to address concerns that the legislation would force too many entities into this more stringent regime, the Dodd-Frank Act included a "*de minimis* exception" to the definition of a swap dealer.[4]

APPA and LPPC support the goals of the Dodd-Frank Act and have worked closely with the CFTC and other interested parties to improve its implementation, particularly related to regulations affecting "end users" – that is, nonfinancial parties that enter into swaps to hedge or mitigate their commercial risks. APPA members are "end users." Dozens of new regulations affect our members' businesses, and APPA and a coalition of not-for-profit electric utilities have submitted formal comments on 17 specific regulations from the CFTC and Securities and Exchange Commission (SEC) related to implementation of the Dodd-Frank Act.

One such instance is the rule defining swap-dealer,[5] which 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 had to register as swap dealers by December 31, 2012. However, the CFTC issued several no-action letters that allow swap dealers to delay their compliance with most of the business conduct and documentation standards until July 2013.

As written, the swap-dealer definition will substantially hinder government-owned utilities' ability to hedge against operational risks. These utilities have no shareholders, so the costs imposed by this regulatory decision will be borne by only one group: our members' customers.

In December 2010, the CFTC jointly with the SEC issued a proposed rule to define the term "swap dealer," including (as required by the statute) 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 (government-owned utilities).

In February 2011, the Not-For-Profit Electric End User Group (NFP EEU)—which includes APPA and LPPC —filed comments on the proposed swap dealer rule. The comments

[2] 7 USC § 6s(h)(4).

[3] 7 USC § 6s(h)(5).

[4] 7 USC § 1a(49)(D).

[5] CFTC Regulation 1.3(ggg)(4); see 77 Fed. Reg. 30596, at 30744.

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 $3 billion. During an initial phase-in period, this threshold will be $8 billion. 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.[6]

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 will severely limit their swap-dealing activities with government-owned utilities to avoid exceeding the $25 million threshold.

<u>Why Hedging Is Necessary</u>

Government-owned 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 government-owned utilities to secure electric energy, fuel for generation, and natural gas supplies for delivery to consumers at reasonable and stable prices.

Specifically, many government-owned 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 government-owned utilities are subject. Additionally, many government-owned utilities have traditionally used the swaps and futures products to hedge their excess electrical 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, government-owned utilities are engaged in commercial risk management activities that are no different from the operations-related hedging of an investor-owned utility or an electric cooperative located in the same geographic region.

<u>Why Nonfinancial Counterparties Are Necessary</u>

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, natural gas, and the like. 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

[6] 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.

electricity for future use, unlike other commodities such as gasoline, grain, coffee, etc. is not currently viable 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 electrical generation facilities and distribution utilities, whether investor-owned utilities, cooperative utilities, merchant generation companies, or government-owned utilities, operate in their geographical proximity and, as they balance their generation to meet changing demands on an hour-to-hour basis, 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 electric grid and ensuring that sufficient liquidity exists to manage their operations.

Because there are a limited number of counterparties for any particular operations-related swap sought by a utility, each financial and 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.

Government-Owned Utilities' Petition for Rulemaking

On July 12, 2012, APPA, 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 government-owned utilities without danger of being required to register as a "swap dealer" solely because of its dealings with government-owned utilities.

Specifically, the petition asks for a narrow exclusion:

- A government-owned 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.

<u>CFTC "No Action" Letter</u>

The CFTC released on October 12, 2012, a no-action letter relating to the $25 million special entity sub-threshold. The letter allows a counterparty to deal in up to $800 million in swaps with government-owned utilities without being required to register as a swap dealer. As the CFTC 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, however, also 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, but it could also be that counterparties, in general, 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 our members.

A November 19, 2012, letter to the CFTC explaining this outcome has failed to produce any further action from the CFTC, though several commissioners have indicated that they believe that relief is appropriate.[7] They have also indicated that absent action by the CFTC, legislation to address this issue directly would be appropriate.[8]

<u>The Public Power Risk Management Act</u>

On March 11, 2013, the Public Power Risk Manage 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). As of May 1, 2013, the legislation had 35 cosponsors.

The legislation largely mirrors the intent and effect of the NFP EEU petition to the CFTC, providing narrowly targeted relief for operations-related swaps for government-owned utilities. Specifically, the legislation would provide that the CFTC, in making a determination to exempt a swap dealer under the *de minimis* exception, shall treat a utility operations-related swap with a utility special entity the same as a utility operations-related swaps 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 government-owned power or 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.

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 prohibits interest, credit, equity, and currency swaps from being considered as 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 swap reporting requirements.

When implemented, this legislation should provide the certainty to nonfinancial entities that they can enter into swap transactions with government-owned utilities 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.

<u>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 that you support a similar</u>

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[7] Statement of Commissioner Bart Chilton, Commodity Futures Trading Commission, “The End User Bill of Rights” (http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement040313) (stating that “Public power end-users using swaps to hedge commercial risk should have the same access to risk management markets as privately-owned utilities.”).

[8] *Ibid*. (stating that action should be taken “preferably through regulatory relief.” However, in comments to reporters Commissioner Chilton stated that absent regulatory relief, legislation would be appropriate).

legislative fix, either as a standalone bill or as part of the Committee's consideration of the CFTC reauthorization.

Conclusion

In conclusion, the protections the CFTC is trying to afford through the $25 million special entity sub-threshold are not needed for utility operations-related swaps entered into by government-owned utilities.

Government-owned utilities are well-versed in the markets in which they are hedging their risks and rely on these swaps solely to manage price and operational risks.

More importantly, the assumption that financial firms will be able to replace all the swaps offered currently by our nonfinancial swap partners reflects a dangerous misunderstanding of how electricity is delivered and an indifference to the price Wall Street will impose in the absence of adequate competition.

In sum, a failure to allow the narrow relief provided under the Public Power Risk Management Act or similar legislation will limit our members' ability to hedge against risks and lead to increased risk and costs to the ratepayers they serve.

Thank you again for this opportunity to present our views. Both APPA and LPPC and our members would be more than happy to answer any questions you might have.

Sincerely,

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