Joint Association Letter Regarding the OTC Derivatives Issue

January 21, 2010

Dear Senator:

The undersigned associations represent all the major segments of the electric power and natural gas industries serving every consumer in the United States. We are writing to express our recommendations to address oversight and transparency of over-the-counter (OTC) derivatives markets. While we support the goals of the Administration and the Congress to improve transparency and stability in OTC derivatives markets, it is essential that policy makers preserve the ability of companies to access critical energy-related OTC derivatives products and markets. Our members rely on these products and markets to manage price risk and help keep costs stable and affordable for consumers.

When discussing any increased regulation of OTC derivatives markets, it is important to note that these transactions are not the source of systemic risk in the broader economy. In fact, the entire commodity market is less than one percent of the global OTC derivative market, and the energy commodity portion is yet a fraction of that one percent. Congress should therefore maintain an appropriate balance between establishing market oversight rule that allows for prudent use of market-based risk management tools and providing regulators with the ability to establish a high level of transparency and the tools needed to protect consumers against market manipulation and systemic risk.

Our members believe that effective OTC derivatives reform should:

- **Provide a clear exemption for commodity market end-users of OTC derivatives products,** such as electric and gas utilities that use OTC derivatives markets to primarily hedge against commodity price risk associated with their business. End-user transactions in commodity derivatives do not contribute to systemic risk, and, therefore, these end-users should be exempted from any definitions of swap dealer and major swap participant.

- **Promote clearing of standardized derivatives between large financial dealers**, where appropriate, through regulated central counterparties to reduce systemic risk and bring additional transparency through information regarding pricing, volume and risk. However, **our members are opposed to mandates that would require all or most OTC energy derivatives transactions to be centrally cleared or executed on exchanges**. The available evidence shows that clearing would **<u>not</u>** bring pricing benefits that would offset the cost of margining for energy derivatives, as some have suggested. In fact, the high cash margin requirements of clearing would significantly increase transaction costs for our members and, ultimately, their retail customers. In addition, it would tie up needed cash at a time when the cost of capital is high, access to capital markets is uncertain, and our industry needs to invest billions in renewable energy sources and new energy infrastructure. As a result, our more capital-constrained members may choose to hedge fewer of their transactions, thereby increasing their risks and passing potentially volatile pricing onto retail customers.

- **Promote greater regulatory oversight and transparency of OTC derivatives through increased financial reporting** and authority to the Commodity Futures Trading Commission (CFTC) to prevent manipulation of the derivatives markets. We believe that this transparency can be achieved in a much more cost-effective way through mechanisms such as mandatory reporting requirements and a central data repository, as opposed to mandatory clearing for energy.

- **Promote the harmonization and clear delineation of regulatory authorities** and functions among the Securities and Exchange Commission (SEC), the CFTC, the Federal Energy Regulatory Commission (FERC) and other Federal agencies to ensure similar products are governed by similar standards. Accordingly, such harmonization should also work to minimize the burden and cost of compliance with regulatory oversight. As an example, we believe that **all electricity products and services provided under a FERC-approved tariff and subject to regulatory oversight by the FERC should be exempt from duplicative regulation by the CFTC.**

- **Amend the proposed definition of a swap to ensure that physical transactions with enforceable delivery obligations are excluded from the definition of swap.** Amend the proposed exclusion from the definition of swap that currently reads "a non-financial commodity or security for deferred shipment or delivery, so long as the transaction is <u>physically settled</u>" to "a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction <u>contains an enforceable delivery obligation</u>." In order to avoid unnecessary costs (e.g., where a party sits in a chain between the producer and ultimate user of a commodity) and for administrative convenience, many physical transactions are settled through a book-out, which is an agreement between two parties to a forward contract to settle their respective obligations with a cash payment, as opposed to making and taking physical delivery. Book-outs have been exempted under CFTC rules since 1993.

Simply put, electricity and gas companies engage in risk management transactions in the OTC derivatives markets to help ensure stable and affordable rates for our customers by helping to hedge against price volatility in natural gas and wholesale electric power - two of the most volatile commodities. We stand ready to work with you to craft OTC derivatives reforms that enhance transparency and improve overall market functions without creating adverse unintended consequences and increased costs for us and the consumers we serve.

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

America's Natural Gas Alliance, American Exploration and Production Council, American Gas Association, American Public Power Association, American Wind Energy Association, Edison Electric Institute, Electric Power Supply Association, Independent Petroleum Association of America, Interstate Natural Gas Association of America, Large Public Power Council, Natural Gas Supply Association, National Rural Electric Cooperative Association, and US Oil & Gas Association.