

# End-User Perspective on Financial Reform

GasMart 2010

May 12, 2010 – 9:00 a.m.

**A UNIQUE ISSUE: UNIFIED THE ENTIRE ENERGY INDUSTRY**



# Financial Reform: For Discussion

---

- Many Goals We Support
- Two Concerns
- What We're Seeking/Capitol Hill Update
- CFTC Reg's: SPDCs and Position Limits

# My Background

---

- My background:
  - Five years Navy Supply Officer in Naval Reactors program
  - MBA in Finance from NYU
  - Worked in bond research covering power cos. at BofA
- My work at EEI:
  - Analyze industry financial information for EEI leadership, EEI members and the public
  - Advise members on emerging financial issues
  - Develop and advocate EEI positions on wholesale markets issues

# Many Financial Reform Goals We Support

---

- ✓ Greater regulatory oversight and public transparency
- ✓ Preventing market manipulation
  - CFTC already acting on Significant Price Discovery Contracts including ICE Henry Hub natural gas
- ✓ Closing the London, Swaps, Enron Loopholes
  - London: Extend regulation to transactions on foreign boards of trade
  - Swaps: Presently enables avoidance of position limits for institutional investors
  - Enron: Partially shut in 2008 (“SPDCs”); OTC energy derivatives still exempt
- ✓ Addressing systemic risk and excessive leverage

# “On Exchange” vs. OTC: Reasons for Both

---

## On Exchange (DCMs):

- Risk management and price discovery
- Standardized products
- Unknown counterparties
- Counterparty analysis not performed (trader faces the exchange)
- Centrally cleared (risk centralized to FCMs)
- Contracts secured with cash margining

## Over-The-Counter:

- Risk management (price discovery = call competing dealers)
- **Standardized and customized products**
- Two known counterparties
- Counterparties analyze each other's credit
- Sometimes centrally cleared
- **Contracts secured with credit agreements, non-cash collateral (e.g., power plants) and/or cash margining**

# Utility Industry Concern: Access to Customized Trades

---

- The benefits of customization would be impossible with mandatory clearing and/or exchange trading, for example:
  - Delivery to specific nodes or trading hubs
  - Non-standard (e.g., very long) timeframes
  - Options to adjust for weather conditions
- Customization also facilitates "hedge accounting," whereas clearing and necessary standardization could reduce effective accounting hedges and lead to:
  - More volatile earnings
  - Higher cost of capital
- Bottom Line: Customers exposed to higher prices, greater volatility.
  - Our members would not be able to hedge a significant portion of their fuel and power risk... because some hedges are too customized (terms and conditions) to execute on an exchange.

# Utility Industry Concern: Access to Efficient Credit Terms

---

- Currently, companies can use illiquid assets like plants, land and equipment to collateralize OTC risk management transactions.
- Clearinghouses require cash or Treasuries as collateral.
- Clearinghouses revalue or “mark-to-market” derivative contracts on a daily or intraday basis and adjust collateral requirements accordingly.
- Cash collateral (i.e., cash margin) must therefore be posted/adjusted one or more times per day for all centrally-cleared transactions.
- Because derivatives used in risk management are generally long-dated transactions – outstanding for weeks, months or years – counterparties experience very large paper gains and losses. Cash margining means that cash in very large amounts must change hands as the performance bond.
- Bottom Line: Reduced investment and/or higher customer rates. Our members would need to divert capital projects or finance cash margins in the capital markets.

# Avoiding Unintended Consequences

January 2010

## OTC Derivatives Reform: Energy Sector Impacts

The slide displays a collection of logos for various energy industry associations and organizations. On the left side, from top to bottom, are the logos for the American Gas Association (AGA), AXPC (American Xcelerator Power Company), American Public Gas Association, APFA (American Public Power Association), AMERICAN NATURAL GAS ALLIANCE, and EEI (Edison Electric Institute). On the right side, from top to bottom, are the logos for EPSA (Electric Power Supply Association), ICAA (International Council on Air Pollution), National Rural Electric Cooperative Association, NCSA (National Gas Supply Association), and PJM (PJM Interconnection).

- Detailed examples from the energy coalition:
  - 5-15% increases in retail customer costs
  - For a regulated T&D utility, \$300-400MM in cash margin and as many as 400 jobs
  - **Constrained risk management >> higher, more volatile costs and reduced investment**

# Pending Legislation: Focus Areas

---

- Definition of “swap” and exclusions
- Definition of major swap participant (MSP)
- Exemptions from clearing
- FERC-CFTC overlap

# Derivatives Reform Should Include the Following Attributes

---

- Preserve access to OTC derivatives markets for energy end-users so that they can continue to manage risk in a cost-effective way
  - Provide a clear exclusion of energy end-users from the definition of an MSP
  - Exempt end-user transactions from the presumption of clearing for standardized swaps
- Promote greater regulatory oversight and transparency of OTC derivatives through mechanisms such as a trade information warehouse
- Amend the definition of a swap to ensure that physical transactions for deferred shipment or delivery are excluded
- Address any findings of excessive speculation in OTC derivatives through proven regulatory tools
- Promote the harmonization and clear delineation of regulatory authorities: CFTC, SEC and FERC

# H.R. 4173, Wall Street Reform and Consumer Protection Act of 2009

---

- Regulation of Derivatives is Title III
- Other titles cover:
  - Systemic Regulation/Financial Services Oversight Council
  - Changes in Bank Holding Company Regulation
  - Resolution Authority
  - Consumer Financial Protection Agency
  - Regulation of Advisers to Hedge Funds and Others
  - Limits on Federal Reserve
  - Executive Compensation and Corporate Governance
  - Credit Rating Agencies, Federal Insurance Office, etc., etc.

# H.R. 4173, Wall Street Reform and Consumer Protection Act of 2009 (cont'd)

---

- Law firms have referred to the “Regulatory Reform Marathon” – HR 4173 is 1,000+ pages
- On derivatives, a major step in the right direction:
  - End-users excluded from definition of MSP
  - Exempts non-dealers/MSPs (i.e., end-users) from the presumption of clearing for standardized swaps (i.e., swaps must be cleared if accepted by a clearinghouse and required to be cleared by CFTC/SEC)
  - Attempts to address book-outs of transactions intended for physical settlement

# Dodd-Lincoln Bill in the Senate

---

- Contains a commercial end-user exemption
  - Appears to exempt end-users from the presumption of clearing for standardized swaps
  - Contains very broad definitions of Swap Dealer and Major Swap Participant
- 
- Continuing amendment process this week
  - Senate may wrap up before Memorial Day; we expect will send bill to President before the mid-term elections

# Pending CFTC Regulation

---

- Significant Price Discovery Contracts (SPDCs):
  - Contracts traded on Exempt Commercial Markets (ECMs) that meet certain criteria as defined by CFTC
  - For electricity, would require ICE to comply with CFTC core principles and additional reporting
  - EEI comments focused on concern that subject contracts do not meet CFTC criteria (including lack of liquid alternatives on DCMs/NYMEX)
  - Process could be rendered irrelevant by pending legislation

# Pending CFTC Regulation (cont'd)

---

- Energy Commodity Position Limits:
  - CFTC would impose new federal limits on positions in futures and options contracts on natural gas, crude oil, heating oil, gasoline blendstock
  - Currently, these are subject to exchange-administered position limits and position accountability levels that are “certified” (approved after the fact) by the CFTC
  - EEI comments offered several recommendations for improvements to the proposed rules:
    - Remove new “crowding out” provisions
    - Aggregate accounts based on control rather than 10% ownership
    - Clarify that future changes to limits will not affect outstanding trades

# Contact Information

---

Aaron Trent

Manager, Financial Analysis

202-508-5526

[atrent@eei.org](mailto:atrent@eei.org)

# Reasons for an End-User Exemption

---

- Key argument for clearing: Ensure an end-user does not cause systemically-risky defaults when a trade or trades (i.e., hedges) go against them.
- What happens when a utility or power producer's hedge goes against them?

## SELLER (e.g., IPP):

Sells power forward @ \$50/MWh  
Spot price rises to \$100/MWh  
Right-way risk >> at expiry, sells into market  
at \$100/MWh  
Keeps \$50 and pays \$50 to hedge provider

## BUYER (e.g., integrated utility):

Buys gas for consumption @ \$6/mmBtu  
Spot price falls to \$4/mmBtu  
Regulatory compact >> at expiry, buys in  
spot market at \$4/mmBtu  
Pays \$2 difference to hedge provider and  
recovers full \$6 as part of normal  
ratemaking process

# End-User Exemption: Other Concerns

---

- Concern: Exemption would also exempt dealers on other side of the trades.
- Mitigated because:
  - End-user transactions are <10% of outstanding OTC transactions (BIS data); CFTC Chair Gensler believes clearing financials' 90% will be sufficient.
  - All trades (exempt or not) would now be transparent to regulators.
- Concern: End-users would get better pricing by trading on exchanges.
- Mitigated because:
  - End-users already execute many hedging transactions on exchange.
  - Wall Street remains highly competitive, and end-users shop around their OTC deals.

# End-User Exemption: Other Concerns (Cont'd)

---

- Concern: Smart bankers/funds will buy commercial assets and “drive truck” through the exemption.
- Mitigated because:
  - Current language in Senate would allow exemption only to an entity whose primary business is non-financial and only when hedging commercial risk.