BEFORE THE
UNITED STATES SENATE

COMMITTEE ON ENERGY AND NATURAL RESOURCES

TESTIMONY OF THE HONORABLE GARRY BROWN,
CHAIRMAN, NEW YORK STATE PUBLIC SERVICE COMMISSION

ON BEHALF OF THE
NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

ON

"Financial Transmission Rights and Other Electricity Market Mechanisms"

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National Association of
Regulatory Utility Commissioners
1101 Vermont Ave, N.W., Suite 200
Washington, D.C. 20005
Telephone (202) 898-2200, Facsimile (202) 898-2213
http://www.naruc.org

Good morning Chairman Bingaman, Ranking Member Murkowski, and Members of the Committee:

My name is Garry Brown, and I am Chairman of the New York State Public Service Commission (NY PSC). I also serve as Chair of the Electricity Committee of the National Association of Regulatory Utility Commissioners (NARUC), on whose behalf I am testifying here today. I am honored to have the opportunity to appear before you this morning and offer our perspective on financial transmission rights and electricity market mechanisms.

NARUC is a quasi-governmental, non-profit organization founded in 1889. Our membership includes the public utility commissions serving all States and territories. NARUC's mission is to serve the public interest by improving the quality and effectiveness of public utility regulation. Our members regulate the retail rates and services of electric, gas, water, and telephone utilities. We are obligated under the laws of our respective States to assure the establishment and maintenance of such utility services as may be required by the public convenience and necessity and to assure that such services are provided under rates and subject to terms and conditions of service that are just, reasonable and non-discriminatory.

Congress is currently considering financial reform legislation with the goal of ensuring that gaps in regulation, oversight of markets and systemic risk do not lead to economic instability, but improve transparency and reduce systemic risk in the over-the-counter (OTC) derivatives markets. NARUC has consistently supported federal legislative and regulatory actions that fully accommodate legitimate hedging activities by electric and natural gas utilities; however, we are concerned that some legislative proposals could have adverse effects on the retail rates of electric and natural gas consumers.

It is our understanding that some of the proposals being contemplated by Congress would provide the Commodity Futures Trading Commission (CFTC) with oversight of OTC risk management products, including mandatory centralized clearing and exchange trading of **all** OTC products. NARUC believes that this approach could be detrimental to electricity and natural gas retail consumers. There is a diverse group of end-users, consisting of electric and natural gas utilities, suppliers, customers, and other commercial entities who rely on OTC derivative products and markets to manage electricity and natural gas price risks for legitimate business purposes, thereby helping to keep commodity costs stable for retail consumers. In these situations, the mandatory centralized clearing of all OTC contracts—as envisioned in proposed legislation—will increase expenses associated with hedging activity, and ultimately end-user prices, due to increased margin requirements.

Electric and natural gas companies use derivatives to "hedge," or lock in, the price of commodities they plan to buy or sell in the future. These companies use clearinghouses and exchanges (such as the New York Mercantile Exchange or NYMEX) when those markets provide the best deal. Often, however, OTC transactions – which are arranged company-to-company or between a company and a bank – provide the lowest cost and/or the most stable pricing. In centralized clearing and exchange trading, the clearinghouse or exchange steps between buyers and sellers and guarantees payment by requesting a significant cash "margin" from both parties. These cash margins, a form of collateral, represent a portion of the value of each contract. For companies whose core businesses involve buying and selling energy commodities, cash margin requirements would translate into significant additional borrowing costs and/or reduced investment, which could require new borrowing at a time when business loans and other financing are both more expensive and harder to get.

State utility commissions regulate companies that rely on legitimate hedging activities and transactions in natural gas and electricity markets to keep commodity costs stable for retail customers. These companies use both exchange-traded and OTC derivatives to reduce their exposure to volatile spot markets, which enables them to make sound medium- and long-term business decisions. A requirement for mandatory centralized clearing of all OTC contracts would increase the expenses associated with hedging activity, and ultimately consumer prices, due to increased margin requirements.

Utilities would have to finance needed cash margins in the capital markets -- and pass those costs to customers through the ratemaking process -- or take other offsetting actions, such as cutting back capital projects. Similarly, public utilities could lose access to long-term electric power supply contracts called pre-pays because the expense of ongoing cash margins would be prohibitive. We also understand that rural electric cooperatives could be forced to borrow large sums at unaffordable rates. In cases where these costs would prove to be too high, the energy supplier would need to reduce or even cease hedging altogether, thus negatively impacting the ability to manage price volatility—resulting in higher costs to consumers. In short, consumers need the industry to have both cleared and OTC options available to provide price stability and lower costs.

Additionally, the effect of margin requirements resulting from mandatory clearing for electric utilities could have the unintended consequence of reducing or eliminating legitimate hedging practices and jeopardizing or reducing investments in Smart Grid technology and other infrastructure; similarly, natural gas utilities and production companies could reduce capital devoted to infrastructure and natural gas exploration.

We believe that the laudable goals of reform that ensure market transparency and adequate regulatory oversight can be accomplished by means other than mandatory clearing of OTC risk management contracts and the anticipated extra expense. For example, a requirement that natural gas and electric market participants engaging in legitimate hedging report all OTC derivative transactions to a centralized data repository, like the CFTC, would provide sufficient market transparency without the costs associated with mandatory clearing.

We recognize the intent of the legislation to minimize or eliminate manipulation in the OTC market, especially by speculators. One approach to address this concern is to have the mandatory requirements and a carefully crafted exemption from the requirements for legitimate utility transactions.

Another concern that NARUC members have is the effects the various legislative proposals may have upon electric transmission entities. The proposed reforms, as we understand, would cause regulatory uncertainty with regard to the oversight of Regional Transmission Organizations (RTOs) and Independent System Operators (ISOs). This uncertainty and/or overlapping jurisdiction can lead to negative impacts on liquidity, market confidence and reliability.

NARUC believes the Federal Energy Regulatory Commission (FERC) and, for the Texas/ERCOT region, the Public Utility Commission of Texas (PUCT), as the regulators with the necessary expertise and statutory mandates to oversee wholesale electricity markets to protect the public interest and consumers, should not be preempted by financial reform legislation from being able to continue exercising their authority to protect consumers and ensure reliable, just

and reasonable service. Energy markets currently regulated by FERC and the PUCT under accepted tariffs or rate schedules should continue to be subject to FERC or PUCT jurisdiction, including over physical and financial transmission rights and market oversight, and should not themselves be subject to CFTC jurisdiction as a clearinghouse due to the financial and other settlement services they provide those transacting in regional electricity markets.

In conclusion, NARUC supports passage of financial reform legislation ensuring that electric and natural gas market participants continue to have access to OTC-risk management products as tools in their legitimate hedging practices to provide more predictable and less volatile energy costs to consumers, and would respectfully offer the following policy recommendations for inclusion in any financial reform legislation:

- The legislation should weigh the costs of potential end-user utility cost increases versus the benefits of new standards for the clearing of OTC-risk management contracts used by natural gas and electric utilities for legitimate hedging purposes.

- Any federal legislation addressing OTC-risk management products should provide for an exemption from mandatory clearing requirements for legitimate utility hedging activity in natural gas and electricity markets.

- Any exemption to the mandatory clearing requirement for OTC derivatives should be narrowly tailored so as not to allow excessive speculation in natural gas and electricity markets.

- FERC should continue to be the exclusive regulator at the Federal level—and the PUCT for Texas/ERCOT—charged with the statutory obligation to protect the public interest and consumers, with authority to oversee any agreement, contract, transaction, product, market mechanism or service offered or provided pursuant to a tariff or rate schedule filed and accepted by the FERC, or the PUCT for Texas/ERCOT.

Thank you and I would be happy to answer any questions.