

Testimony of the Honorable Glenn English, CEO
National Rural Electric Cooperatives Association

Before the

United States House of Representatives
Committee on Agriculture

September 17, 2009

Mr. Chairman, Ranking Member Lucas and Members of the Committee, thank you for inviting me to discuss the perspective of electric cooperatives regarding the U.S. Department of Treasury's proposal to regulate the over-the-counter (OTC) derivatives market. The National Rural Electric Cooperative Association (NRECA) is the not-for-profit, national service organization representing nearly 930 not-for-profit, member-owned, rural electric cooperative systems, which serve 42 million customers in 47 states. NRECA estimates that cooperatives own and maintain 2.5 million miles or 42 percent of the nation's electric distribution lines covering three-quarters of the nation's landmass. Cooperatives serve approximately 18 million businesses, homes, farms, schools and other establishments in 2,500 of the nation's 3,141 counties.

Cooperatives still average just seven customers per mile of electrical distribution line, by far the lowest density in the industry. These low population densities, the challenge of traversing vast, remote stretches of often rugged topography, and the increasing volatility in the electric marketplace pose a daily challenge to our mission: to provide a stable, reliable supply of affordable power to our members—including constituents of many members of the Committee. That challenge is critical when you consider that the average household income in the service territories of most of our member co-ops lags the national average income by over 14%.

Mr. Chairman, the issue of derivatives and how they should be regulated is something with which I have a bit of personal history going back twenty years in this very committee. Accordingly, I am grateful for your leadership, in pursuing the reforms necessary to increase transparency and prevent manipulation in this marketplace.

From the viewpoint of the rural electric cooperatives, the U.S. Department of Treasury's proposal to regulate the \$600 trillion over-the-counter (OTC) derivatives market can be boiled down to a single, simple concern that I know you have heard me articulate before: affordability.

NRECA's electric cooperative members, primarily generation and transmission members need predictability in the purchase price for their inputs if they are to provide stable, affordable prices to their customers. Rural electric cooperatives use derivatives to keep costs down by reducing the risks associated with both volatile energy prices and financial transaction costs. It is important to understand that electric co-ops are engaged in activities that are pure hedging, or risk management. We DO NOT use derivatives for other purposes. We are in a difficult situation, but OTC derivatives are currently the best tool we have to manage risk.

Most of our hedges are bilateral trades on the OTC market. Many of these trades are made through a risk management provider called the Alliance for Cooperative Energy Services Power Marketing or ACES Power Marketing, which was founded a decade ago by many of the electric co-ops that still own this business today. Through ACES, our folks make sure that the counterparty taking the other side of a hedge is financially strong and secure.

Half of the electric cooperatives' finance needs are met by private cooperative lenders, including the National Rural Utilities Cooperative Finance Corporation (CFC). Derivatives, specifically interest rate and currency swaps, are an important asset/liability management tool for cooperative lenders. As a cooperative lender, CFC is not a broker or dealer, nor does it invest in derivatives for trading or speculative purposes. It uses derivatives to manage currency and interest rate risk, and thereby affords our electric cooperative borrowers more loan options. While hedges are necessary for electric co-ops, they pose risks. If a counterparty does not pay up, there will be severe consequences for our members, so we are extremely careful about who we trade with and for how much. Our consumers expect stable, affordable electricity prices, and electric suppliers need the OTC markets to manage the price volatility risk for our consumer-owners.

Even though the financial stakes are serious for us, rural electric co-ops are not big participants in the derivatives markets. I mentioned earlier that this market is estimated at \$600 trillion dollars. Our members have a fraction of that sum at stake and are simply looking for an affordable way to hedge. Because many of our co-op members are so small, legislative changes that would dramatically increase the cost of hedging or prevent us from hedging all-together will impose a real burden.

Electric cooperatives are owned by their consumers. Those very consumers expect us, on their behalf, to protect them against volatility in the energy markets that can jeopardize small businesses and adversely impact the family budget. The families and small businesses we serve do not have a professional energy manager. Electric co-ops perform that role for them and should be able to do so in an affordable way.

Our primary concern with the Treasury Department's proposal is that it would require most of our transactions to be cleared since our natural gas trades likely would be considered "standardized". And, before going further, I want to remind you that we are NOT looking to hedge in an unregulated market. NRECA DOES want derivatives markets to be transparent and free of manipulation. The problem is that requiring all derivatives contracts to clear is just not affordable for most co-ops. That is because the initial and the "working" or "variance" margin we would have to provide would make hedging untenable for many of our members – we would have to come up with hundreds-of-millions of dollars in cash that we just do not have on hand.

In general, co-ops are capital constrained due to other capital demands, such as building new generation and transmission infrastructure to meet load growth, installing equipment to comply with clean air standards, and maintaining fuel supply inventories, not to mention the fact that as member-owned cooperatives, we cannot go to the equity markets for additional resources. Maintaining 42% of the nation's electrical distribution lines requires considerable and continuous investment.

We have the same concern with Treasury's proposal to require higher capital and margin requirements for non-standard products that are not cleared; it comes back to the need for predictable affordability.

Clearing also presents a significant potential predictability issue. In case of a catastrophic event, the marketplace could change dramatically in a very short timeframe. If a catastrophic event triggered market concern over fuel supplies, ratings could shift and the prices for contracts could swing dramatically, triggering a sizable margin call for a reason unrelated to the original trade. A co-op in that position would not have the cash reserve to cover the margin call, leaving only one, unattractive option –to borrow a large sum at unaffordable rates.

Rural electric cooperatives do trade on exchange (and thus have some trades cleared) when we can. Electric cooperatives customarily have a couple thousand trades at any given time on NYMEX, but due to the working margin requirements associated with clearing, most of our trades are made on the OTC market. We don't like this situation, but we feel pushed into hedging on the OTC market by the cost. We would like to be able to trade everything on an exchange or go through a clearinghouse, but many of our members just cannot afford it.

Another concern with the Treasury Department's proposal is that for the electric power supply and natural gas business engaged in trading actual electricity or natural gas, the exemption for any transaction that is "physically settled" requires further clarification to exempt transactions already regulated by the Federal Energy Regulatory Commission (FERC), such as virtual bidding in day-ahead markets or the purchase or sale of Financial Transmission Rights, market capacity, and similar products in the organized markets. Importantly, many bilateral physical electric and natural gas transactions are "booked-out" before delivery, for physical scheduling efficiencies. These "booked out" transactions which are already regulated by FERC should not be subject to additional regulation. Absent this clarification, the proposal could accidentally put such transactions within the domain of derivatives regulation.

Mr. Chairman, at the end of the day, we are looking for a legitimate, transparent, predictable, and affordable device with which to hedge. I know there are many ideas under consideration, but regardless of what specific solution is arrived at, I know that you and your committee are working hard to ensure these markets function effectively. The rural electric co-ops just hope that at the end of the day, there is a way for the little guy to effectively manage risk.

Thank you.