



**Balancing Consumer Protection and  
Risk Management:  
Over-the-Counter (OTC) Derivatives  
Reform**

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# Why Do Utilities Trade?

- We are primarily hedgers and risk managers; we are not speculators
  - Our trading goals are to insulate customers from commodity price volatility and to help stabilize and keep energy costs for our customers affordable
- We trade in:
  - Wholesale electricity
  - Wholesale natural gas
  - Coal
  - Refined Products (fuel oil)
  - Emissions (SO<sub>2</sub>, NO<sub>X</sub>, CO<sub>2</sub>)

# What is Risk Management?

- Risk management tools help us control risks associated with our core business activities
- “Hedgers” manage price risks associated with the purchase or sale of an actual commodity
- By contrast “speculators” or “pure traders” voluntarily bear the risk of uncertain future prices in exchange for the potential to profit. They provide needed liquidity to markets
- Both have roles in the commodities markets

# What is a Derivative?

- Derivatives are financial contracts, or financial instruments, whose values are “derived” from the value of something else
- Derivatives are used for risk management
- Forwards, futures, swaps and options are all derivative contracts
- Utilities and energy companies make extensive use of derivatives to hedge – or “lock in” – future prices of natural gas and power
- Over the counter or “OTC” transactions are risk management transactions agreed to between two parties without using a NYMEX-like exchange or clearinghouse
- OTC transactions are not “one size fits all” because the parties typically enter into them to fit their particular circumstances
  - Parties to OTC transactions rely on each other’s credit (balance sheet, other assets, etc.) to back up the transaction
  - Cash “margin” is not required

## Some Proposals to Regulate OTC Derivatives are Problematic

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- The goals of financial reform legislation pending in Congress are to address “systemic risk” and to promote greater transparency in financial markets
- Some advocates are calling for mandatory central clearing for energy derivatives transactions
  - Commodities are less than 1% of the global OTC market
  - OTC energy derivatives trading simply does not pose a systemic risk to our financial system; they are not the reason for our financial turmoil
  - New capital and margin requirements should apply only to those sectors where systemic risk exists
  - Transparency can be achieved without mandatory centralized clearing or exchanged-based trading
- FERC already comprehensively regulates wholesale electricity markets; its regulation should be exclusive
  - There is no need to add another layer of CFTC regulation
  - It will only add confusion and additional costs

- Centralized clearing and exchange-based trading require posting of cash or cash equivalents as margin
- Initial margin requirements are typically 9% of the transaction
- Utilities engage in tens of billions of dollars of derivatives transactions annually, the majority of which are OTC, with minimal margin required
- A typical utility would need to post approximately \$250M to \$400M in additional cash margin with mandatory centralized clearing
- Wholesale power prices could increase 5-15%

# Retain Exclusive Jurisdiction for FERC and the PUCT

- FERC (and the PUCT for ERCOT) is currently the exclusive Federal regulator for wholesale power transactions, including RTOs and ISOs
- There should not be two Federal agencies overseeing the same transactions
- Regulatory uncertainty as to the oversight of RTOs and ISOs will lead to negative impacts on consumers and reliability
- Giving the CFTC jurisdiction and oversight over things that are now regulated by FERC/PUCT, such as Financial Transmission Rights (FTRs), could result in duplicative regulation and undermine confidence in markets
- Requiring RTOs and ISOs to register as “Derivative Clearing Organizations” under the authority of the CFTC would result in increased costs to consumers

- OTC derivative risk management tools help keep electric and gas rates stable and affordable for consumers
- The **increased costs** from cash margin requirements will be passed on to consumers
- The **increased risks** will be borne by consumers if customized OTC derivative transactions are not available for tailored risk management solutions
- Capital for infrastructure projects will be reduced and more expensive
- The extra costs do not result in any net risk mitigation benefit nor any net value to consumers