

Statement of Randy S. Howard
On behalf of the City of Los Angeles, Department of Water and Power, and Large Public
Power Council

Before the Committee on Agriculture
United States House of Representatives

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Chairman Lucas and members of the Committee, thank you for this opportunity to discuss the operational and economic impacts to the Los Angeles Department of Water and Power (LADWP) specifically and to electric utilities in general related to the proposed rules implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

I am Randy S. Howard, Director of Power System Planning and Development and Chief Compliance Officer for LADWP. LADWP is a Department of the City of Los Angeles and the largest municipal utility in the country serving approximately 4.0 million people.

I also am testifying on behalf of the Large Public Power Council (LPPC). LPPC consists of roughly two dozen large public power systems that have actively participated in the Commodity Futures Trading Commission (CFTC) rulemaking process, submitting written comments, participating in roundtables, and meeting with CFTC staff.

Electric Utilities use Hedges to Keep the Lights on at Reasonable Rates

Our business is to keep the lights on for customers. To accomplish this, we manage a range of operational and commodity market risks every day to provide power to the residents and businesses we serve.

LADWP, like many utilities, controls operational risks by producing power from a mix of natural gas, coal, nuclear, hydro-electric, bio-fuels, and renewable energy resources. In addition to diversifying our power generation resources, LADWP strategically diversifies the locations of our generating facilities. LADWP owns, operates, and/or contracts generation in seven different western states to provide Los Angeles with reliable electricity service 24-hours a day, 365 days a year. For example, LADWP has wind farm resources in the Southern California Tehachapi mountains, in Utah and Wyoming, and in Oregon and Washington State, that have different wind profiles and at any one time, at least one location should be producing energy.

These physical diversification activities are not enough alone to provide our customers with reliable service at affordable and stable prices. Therefore, it is essential to manage the price volatility inherent in commodity markets such as natural gas and electric power through the use of bilateral contracts, hedges, and options. LADWP, as well as other utilities purchase fuel to generate electricity and buy and sell wholesale power at multiple delivery points. We enter into hedging contracts to control the costs our customers ultimately pay for energy commodities. Many of these transactions are

between LADWP and another commodity end-user and not part of an organized trading market. These transactions have proven to be an extremely effective tool in keeping the lights on and insulating our customers from the energy market risks of price volatility.

As electric utilities, such as LADWP, transition into a higher resource level of renewable energy and proceed with significant reductions in fossil fuel emissions output, the operation and economic risks will increase.

As you know, the inability to predict the weather many months ahead impacts many decisions in the agricultural community, including the desire to hedge price swings. The electric industry is similar in this respect. It is not just the inability to predict weather, but the extreme weather events and the risks of the wind not blowing, the multi-year drought scenarios, the cloudy days when the sun is not shining for the solar systems, or wildfires burning under the transmission lines creating outages that make hedging and options critical to our businesses. These types of hedges and options physically or financially settle. But, all still to hedge commercial risks.

Specific Concerns with Frank-Dodd Implementation

There are four main areas of concern with the ongoing implementation of the Frank-Dodd Act: definitions and sequencing, margining and capital requirements, reporting requirements and business conduct rules for special entities.

Definitions and Sequencing

Several important definitions are still being drafted by CFTC and will impact LADWP and other utilities. In particular, we are concerned that individual LPPC members could be considered a “swap dealer” due to certain transactions we use to hedge our costs. LADWP and the members of LPPC do not belong within this definition, as we hedge strictly to minimize commercial risk and do not contribute to systemic risk of the market. If our utility systems were regulated as swap dealers, our ratepayers – the residents and businesses which we are obligated to serve – would be swept into the same regulatory regime meant to target financial speculation. .

Notwithstanding the recent CFTC Effective Date Order, as a result of continuing uncertainty about how long the “temporary relief” will continue, and about what happens to outstanding longer-term transactions that may fall within the definition of “swap” once the CFTC’s Dodd-Frank Act rulemakings are finalized (under the new regulatory regime for “swaps”), some expect that there will be fewer counterparties willing to enter into transactions with delivery dates or maturities that would extend past that temporary exemptive relief expiration date of December 31, 2011 in the Effective Date Order. In order to execute such longer-term transactions, there may also be additional credit support or collateralization requirements, new qualifications in legal opinions, and new representations and warranties.

Margining and Capital Requirements

Generally, our hedges are not standardized transactions suitable for clearing through financial intermediaries. Instead, our hedges are negotiated directly with counterparties with whom we have longstanding relationships. In particular, this enables us to customize the terms of our hedges, reducing or eliminating the need for collateral posting except where one of the party's credit deteriorates. All over-the-counter transactions do not share the same risk profile. End-users like electric and gas utilities, rural electric cooperatives, and municipalities often rely on their strong credit quality to structure transactions. A one-size fits all approach for determining credit risk would punish more prudent risk managers and holders of strong balance sheets. Accordingly, we think the CFTC should reconsider its counterparty exposure charge in its proposed capital requirements rulemaking. An effective and meaningful end-user exemption is called for in the law and should be reflected in the regulations.

Congress has repeatedly indicated that it did not intend to reduce hedging options for end users or to impose additional costs on end users hedging traditional commercial risks. We are concerned that our customers will experience rate instability and cost increases if Congress' intent is not effectuated through proper implementation of the Dodd-Frank Act. While the Dodd-Frank Act contains provisions exempting end-users from margin and clearing requirements, the CFTC, in issuing its regulations, threatens to render meaningless this statutory protection for end-users.

Recordkeeping and Reporting

We are also concerned that the extent of the reporting requirements proposed by the CFTC, if coupled with onerous penalties for noncompliance, will unnecessarily add significant costs to our hedging transactions and are excessive in light of our relatively modest share of the derivatives market. We have encouraged the CFTC to carefully consider the cost impacts of proposed transaction documentation and reporting mandates on end-users like electric and gas utilities, rural electric cooperatives, and municipalities. These kinds of entities do not generally have large back-office operations dedicated to dealing with swap transactions, and many of the proposed rules will impose completely new requirements on some of these energy end-users. A better analysis of the costs and benefits of these proposed documentation and reporting requirements should be undertaken, in consideration of the low systemic risk associated with end-users like electric and gas utilities, rural electric cooperatives, and municipalities. Further, an adequate amount of time should be provided to these kinds of entities to adjust and transition to a new regime of reporting and documentation.

Business Conduct of Special Entities

Although LADWP and LPPC support the establishment of business conduct standards for counterparties to special entities, we are concerned that the CFTC's regulatory approach imposes excessive burdens on swap counterparties in determining whether special entities have "independent advisors" and uses an overly broad definition of "advisor." We believe that this approach will unnecessarily increase the costs of hedging and cause counterparties to be less willing to enter

into swaps with special entities. The CFTC's regulations should minimize the burdens and potential liabilities for counterparties trading with "special entities." Rules that make it more difficult or risky to do business with "special entities" discourage counterparties from conducting trades with end-users that are special entities, undermining Congress' intent to protect legitimate hedging of risks by end users such as electric utilities. Simple, practical regulations are needed.

Although we are still digesting them, the proposed rules issued by the SEC seem to be more in line with what is needed: dealers can disclaim "advisor" status and dealers can rely on representations to determine that an entity has an independent swap advisor.

Recommendations

CFTC should not impose collateral posting requirements on either party to hedges in which an end-user is a counter-party. LPPC members and their counterparties have historically relied on individually-negotiated credit support and collateral arrangements. Our transactions do not create systemic risk to the U.S. financial system, which is what Dodd-Frank Act seeks to mitigate. While the CFTC has made recent positive statements on this issue, we would hope to see regulations that protect the continued use of hedges that involve end-users such as our utilities.

The Commodity Exchange Act has recognized such an exemption from margin requirements since the 1970's.

Regulations should minimize the burdens and liabilities for counterparties trading with “special entities”. Rules that make it more difficult or risky to do business with “special entities” discourage counterparties from conducting trades with end users such as LPPC members, undermining Congress’ intent to protect legitimate hedging of risks by end users such as electric utilities.

Record-keeping and reporting rules should be crafted to provide transparency in the derivatives markets without interfering with the daily operations of businesses. Rules that allow businesses to report data on reasonable timeframes, including a “CFTC-lite” method of registration, will foster Dodd-Frank’s market transparency goals without imposing unnecessary, and costly instantaneous information reporting mandates.

- a. Energy end-users and public power doesn’t contribute to systemic risk and it is critical that we do not fall under margining rules.
- b. Transparency is not a concern, as public power entities, most entities have very open policies. Quarterly Reporting would accomplish this goal without being overly burdensome – CFTC-lite
- c. Business Conduct – allow counter parties to rely on representation of utility that they have internal expertise sufficient to enter into trades.