One Page Summary of Testimony of Max J. Minzner
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Financial transactions play an important role in today's energy markets. FERC should make thoughtful choices when setting the scope of the products traded in its markets in order to allow them to provide the most benefit to consumers. Financial products should exist in the FERC markets to the extent that they help improve the functioning of the physical energy markets.

Right now, the financial products in the FERC markets generally serve this purpose. For example, virtual bids and offers can reduce price risk and improve reliability by aligning the prices in the day-ahead and real-time market for energy. Similarly, FTRs allow entities to reduce their exposure to the risk of price variations.

However, appropriate regulation of these products by the Commission is important. For example, FERC has correctly worked to ensure appropriate credit requirements that mandate that market participants have the financial ability to cover their obligations they assume. FERC should also carefully coordinate with other regulators. Given its jurisdiction, the CFTC has an important role to play in this area and the two agencies need to work together.

A robust enforcement program is also crucial. Financial products have played a role in many of FERC's recent enforcement actions aimed at market manipulation. The Commission needs to make sure it has the analytic and oversight tools it needs to bring appropriate enforcement actions.

Finally, the Commission should be open to improving its efforts in this area. These markets change quickly. As a result, the Commission should be frequently assessing the financial products in its markets, its regulatory approach, and its enforcement regime.

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Subcommittee on Energy and Power
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Introduction

Mr. Chairman, Ranking Member Rush, and members of the Subcommittee: Thank you for inviting me to testify today. My name is Max Minzner, and I am a partner at the law firm of Jenner & Block LLP. From 2015 until 2017, I was the General Counsel of the Federal Energy Regulatory Commission (FERC or the Commission). From 2009 until 2010, I served as Special Counsel to the Director of the Office of Enforcement at FERC where I helped design and oversee the agency's enforcement program. In my view, the Commission has worked hard to harness the power of markets, subject to regulatory oversight, to ensure the reliable and safe provision of energy to consumers at just and reasonable rates.

I appreciate the opportunity to testify today on financial trading in the electricity markets. Financial transactions are a valuable component of today's markets and appropriate regulatory scrutiny is important to ensure a level playing field and the integrity of the markets. Let me start my testimony be distinguishing between two types of financial transactions. *First*, some transactions occur within the FERC-regulated markets. The Commission oversees six regional organized markets that handle wholesale transactions in electricity. These markets also trade financial products that take their value from the sales of physical energy. *Second*, some transactions in energy derivatives occur outside these markets. To the extent that these transactions are regulated, the Commodity Futures Trading Commission oversees the markets where they are traded.

This division between leads to a core question for Congress and federal regulators: Which products should be traded within the markets regulated by FERC and which products should be traded elsewhere?

In answering this question, I think the Commission and Congress should consider three factors. The first issue is the scope of FERC's jurisdiction. The Commission, at is core, is an agency that regulates transactions in physical energy products. The Federal Power Act and the Natural Gas Act regulate the sale of electricity and natural gas. The Commission is charged with ensuring that the rates, terms, and conditions of service comply with the requirements of those statutes. In contrast, as a general matter, FERC is not considered a financial regulator.

Second, the Commission's jurisdiction shapes the scope of its expertise. The Commission and its staff have a deep understanding of the markets in electricity and natural gas. That understanding is built on eight decades of regulatory oversight under the Federal Power Act and the Natural Gas Act dating back to the work of the Federal Power Commission. Its regulatory experience with financial transactions will necessarily be more limited.

Third, as the Commission authorizes products that are arguably also regulated by other agencies including the CFTC, the potential for regulatory conflict inevitably grows. Joint regulation by multiple agencies can have value, but comes with costs. Shared enforcement authority can provide a second set of eyes to identify and eliminate misconduct. On the other hand, entities that trade in these markets will need to comply with two sets of regulatory mandates. The burden of doing so can be significant.

These factors suggests an answer to the question outlined above. Financial products should exist within the FERC markets to the extent that they are helpful to improve the functioning of the physical energy markets. They should not be created or expanded past the

point at which they are needed to ensure that the physical markets work efficiently and deliver value to consumers.

Right now, I believe the Commission's markets contain financial products that, broadly speaking, play this role. Let me highlight two of those products. The first are virtual bids and offers. Most FERC-jurisdictional markets operate on both a day-ahead and real-time basis. In the day-ahead market, buyers and sellers of power offer their supply and demand of electricity for the following day. These transactions are settled the next day and, to the extent that the supply or demand was not predicted correctly, the real-time market is available to close the gap.

Differences between the day-ahead and real-time prices and quantities can distort market outcomes and lead to inefficiencies. Virtual bids and offers are valuable tools to close these gaps. Financial traders can observe anomalies in the day-ahead market that are likely not to be reflected in the real-time market. Through appropriate bidding strategies attempting to benefit from these anomalies, virtual transactions can cause prices to move and arbitrage away these differences. In certain situations, virtuals can also help reduce or eliminate market power.

Second, many FERC markets offer a product called financial transmission rights or FTRs. These products take their value from the difference in day-ahead energy prices at two different locations on the electric grid. They can provide significant value to consumers of electricity because they allow entities to reduce their exposure to the risk of price variations. For example, load-serving entities have the obligation to provide power to retail customers. FTRs can allow these entities to hedge their risk of transmitting the power they need from generators to their customers.

Allowing financial transactions in FTRs helps provide liquidity and price discovery. A liquid FTR market ensures that the costs of FTRs are neither too high nor too low. Moreover, a

liquid market can help improve decisions about transmission upgrades. Persistently high FTR prices reveal the existence of current or future congestion on the electric grid. These prices signal the need for new construction and assist transmission planners in their work.

These benefits can be best achieved through a sensible and reasonable regulatory framework. Financial transactions need to be appropriately, but not overly, regulated. The Commission should avoid treating financial players differently just because they are financial, rather than physical, participants in the jurisdiction markets. FERC should design the rules to maximize the benefit to consumers from these transactions.

For example, regional variations in organization markets are significant. Each FERC-jurisdictional market has its own unique market rules. These differences suggest that the nature and design of the financial products in each market may need to vary as well.

The Commission should also ensure that the market rules relating to financial products are designed to avoid imposing costs on other market participants. One example of this type of regulation is appropriate credit requirements that ensure that traders have the financial ability to cover the obligations they assume. The Commission has taken important steps to impose such credit requirements and this helps ensure the financial solvency of the markets.

FERC should also carefully consider the interaction between its rules and the requirements imposed by other regulators. Some have argued that aspects of the RTO markets are subject to CFTC regulation because of the nature of the financial products traded in these markets. The CFTC has provided an exemption for these markets given the pervasive regulation of the markets by FERC. Last year, the CFTC considered whether that exemption should extend to the private right of action under the Commodity Exchange Act. Working collaboratively with FERC, the CFTC eventually decided that the exemption should cover that provision as well.

That type of thoughtful joint action by federal agencies will be important in this space moving forward.

Finally, an appropriate and thoughtful enforcement regime is a crucial component of an effective program of regulatory oversight. Financial products have played a role in many of FERC's recent enforcement actions aimed at market manipulation. In particular, the Commission has often targeted a form of misconduct known as cross-market manipulation. Cross-market manipulation occurs when a market participant takes positions in two different, but related, markets. For example, a trader might obtain a large financial position in a product that derives its value from a relatively thinly-traded physical energy product. By making large trades in the physical product, the trader might be able to change its price in ways that enhance the value of the financial position. Even if there is a loss on the physical position, it can be offset by a much greater gain in the financial position.

The Commission's focus on cross-market manipulation is a sensible use of its enforcement authority and has a strong historical pedigree. Congress gave FERC its expanded enforcement authority in the Energy Policy Act of 2005. That statutory change was the direct result of the Western Power Crisis of 2000-2001. An important component of that event was a combination of poor market design and the use of financial products to benefit from the manipulation of the physical energy markets.

Despite its importance, though, cross-market manipulation is not always easy to detect and punish. In some cases, the conduct entirely within a FERC-regulated market because, for example, it involves physical and financial positions traded entirely within an RTO. In such cases, the Commission can "see" the entire transaction making detection more straightforward. On the other hand, though, components of the transaction only occur within the markets that the

CFTC regulates. In such cases, the Commission may only be able to directly observe a part of transaction and will be required to coordinate with the CFTC to obtain other information that it needs. FERC and the CFTC have worked hard to build a collaborative and effective relationship. The Commission to continue those efforts.

To its credit, FERC is an agency that has, from time to time, reexamined its enforcement practices. Let me highlight two of those efforts by FERC staff from November of 2016. First, FERC staff issued a white paper on compliance practices for energy traders. Compliance is a key area for financial traders to consider because an effective compliance program can significantly reduce or eliminate the potential penalty exposure for enforcement targets. Second, staff issued a white paper reviewing the agency's anti-market manipulation efforts over the decade since EPAct 2005. Combined with the agency's annual report on enforcement, these documents provide key guidance to the regulated community about the Commission's enforcement priorities and its view on the scope of its enforcement authority.

These efforts should continue. They are especially important in the area of financial trading. Financial markets inevitably move much faster than regulators. As a result, the Commission should constantly be reevaluating the financial products offered in its markets, the regulatory structure used to oversee these products, and the enforcement regime designed to ensure a level playing field for market participants and just and reasonable rates paid by consumers.