SUBJECT: Hedging contracts for coal and nuclear fuel by municipal electric utilities

COMMITTEE: Regulated Industries — favorable, without amendment

VOTE: 8 ayes — P. King, Christian, Turner, Hartnett, Oliveira, Smithee, Straus, Swinford

0 nays

1 absent — Crabb

WITNESSES: For — Mike Kotara, CPS Energy; Mark Zion, Texas Public Power Association; (*Registered, but did not testify*: John W. Fainter Jr., Association of Electric Companies of Texas, Inc.; Rudy Garza, TXU; Michael McCluskey, Austin Energy/City of Austin; Monty Wynn, Texas Municipal League)

Against — None

On — Barry Smitherman, Public Utility Commission of Texas

BACKGROUND: The electric utility industry in Texas consists of three types of utilities: investor-owned utilities, rural electric cooperatives, and municipally owned electric utilities (MOUs). Under SB 7 by Sibley, et al, enacted by the 76th Legislature in 1999, MOUs may elect to participate in retail competition. Once this decision has been made, an MOU cannot reverse its decision, and retail customers may choose an electric provider.

The Public Funds Investment Act, Government Code, ch. 2256, sets provisions for which state agencies and political subdivisions may invest their funds. SB 7 added sec. 2256.0201 (a), permitting a municipality that owns an MOU to enter into hedging contracts and related security and insurance agreements for fuel oil, natural gas, and electric energy.

Under sec. 2256.0201 (d), hedging means the buying and selling of commodity futures of fuel oil, natural gas, and electric energy. The purpose of hedging contracts is to protect against losses stemming from price fluctuations. The transactions must comply with regulations set forth

by the federal Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC).

DIGEST:

HB 1217 would permit municipally owned electric utilities to enter into hedging contracts for coal and nuclear fuel. The bill also would allow MOUs to enter into hedging contracts for costs related to transporting fuel oil, natural gas, coal, nuclear fuel, and electric energy.

The bill would take immediate effect if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2007.

SUPPORTERS SAY:

HB 1217 would broaden the permissible use of hedging contracts by MOUs and help reduce consumers' vulnerability to price fluctuations in coal, nuclear fuel, and diesel fuel, which is used for transport. As a risk instrument, hedging mitigates against future losses in commodity markets. It primarily would benefit MOUs in San Antonio, Austin, Garland, Bryan, Denton, Greenville, and Brownsville.

Hedging contracts are important long-term mechanisms for MOUs to recover costs and shield electricity rate-payers from price spikes. MOUs and consumers, in turn, assume less risk due to the spreading out of risk exposure in the hedging process. Hedging contracts are especially vital amid the increasing volatility of fuel commodities. In the wake of Hurricane Katrina, the price of coal increased dramatically. Customers would have been less vulnerable to price increases if MOUs had been able to engage in hedging contracts for coal.

Coal and nuclear fuel were not prone to price fluctuations when SB 7 was crafted in 1999, so legislation on electric utility restructuring did not stipulate that MOUs could hedge these commodities. However, prices for coal, nuclear fuel, and fuel-related transportation costs have become less stable amid rising demand. Under these market conditions, long-term contracts with set prices for coal and rail delivery are less widely available. Demand for coal is predicted to increase in future years, continuing the trend of upward pricing pressure and less desire by coal suppliers to contract fixed prices. HB 1217 would update the law by allowing for hedging of these newly volatile commodities.

Many MOUs rely on coal to generate a significant portion of electricity. The out-of-state location of coal suppliers leads to a reliance on diesel fuel

for coal transport. In turn, MOUs see increasingly sizable transportation costs, sometimes more than 50 percent of total delivered costs. The increasing volatility of diesel makes hedging contracts for MOUs in transportation costs especially important. By hedging the cost of diesel fuel, MOUs could further reduce costs to consumers.

HB 1217 would enable MOUs to keep up with changes in the energy market. It would extend the same risk instruments to MOUs that commonly are used by other power producers. If other utility providers can offer consumers fixed prices via hedging contracts, MOUs should be allowed to do the same. The bill would level the playing field and help ensure market efficiency.

Since enactment of SB 7 in 1999, MOUs successfully have entered into hedging contracts for fuel oil, natural gas, and electric energy. This demonstrates MOUs' familiarity with hedging transactions. Oversight by the SEC and CFTC ensure prudent use of hedging contracts, which also are overseen by local authorities. For instance, the Austin City Council has a financial risk management policy for Austin Energy regarding hedging practices.

Hedging contracts are not new or speculative, and MOUs have extensive experience in using these contracts for fuel oil, natural gas, and electric power as a prudent means of insuring against price volatility. Private entities benefit by using hedging contracts in much the same way. For example, Southwest Airlines used hedging contracts to lock in the price of aviation fuel and reaped the benefits over its competitors when aviation fuel prices soared.

While futures markets for uranium and Western coal have yet to emerge, the increasing volatility of prices for these commodities make it likely that new markets will develop in the near future. HB 1217 would grant prospective authority for MOUs to enter these markets and benefit their customers by hedging against price volatility and scarcity for these commodities as these markets emerge.

Only those MOUs that already derive power from existing coal and nuclear generating plants would need to use this authority. Hedging contracts would insure against price volatility regarding existing power generating sources and have no effect on decisions concerning new power sources.

OPPONENTS SAY:

Hedging contracts are a relatively new financial instrument. Despite increasing volatility in prices for these commodities, coal futures markets remain very limited in scope, and no such market exists for nuclear fuels. The New York Mercantile Exchange started a coal futures market in 2001, but only Central Appalachian coal futures are traded. No similar trading arrangement exists for the Wyoming and other western coal transported into Texas. MOUs could potentially be whipsawed by volatility of commodity prices and the lack of liquidity of their financial instruments in a limited futures market.

Most city-owned utilities do not possess the fiscal sophistication to engage in commodities trading through hedging contracts. Permitting expanded use of hedging contracts could increase risk to consumers, as they could be incorrectly used by agencies not specializing in this type of trading.

OTHER OPPONENTS SAY:

The state of Texas should enact initiatives that encourage MOUs to use cleaner, renewable energy sources. HB 1217 would encourage MOUs to lock into contracts for commodities such as coal and nuclear fuel that negatively impact the public health.

NOTES:

The identical companion bill, SB 495 by Van de Putte, passed the Senate by 29-0 on March 20 and was reported favorably, without amendment, by the House Regulated Industries Committee on March 27, making it eligible to be considered in lieu of HB 1217.