Constellation Energy
Comments on Proposed OTC Reforms
Constellation Energy Key Facts

- Constellation Energy is a Fortune 500 company (#125 on the 2009 list).
- Over 26,500 MW 2008 peak load served to retail and wholesale customers
- Approximately 9,000 MW of owned generating capacity (includes diverse portfolio of nuclear, coal, natural gas, oil, renewable)
- Largest competitive supplier of electricity in the United States
Constellation hedges and optimizes supply resources through OTC markets.

5-year strategic plans of critical interest to equity analysts vis-à-vis risk profile.

Over-the Counter & RTO Products fill the imbalance between generation supply and customer demand including:

- Fixed Blocks
- Call/Put Options
- Unit Contingent Energy
- Weather Products
- Firm Transmission Rights

Managing the building blocks to meet customer load profiles

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<th>MW Peak Demand</th>
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<td>January</td>
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Hypothetical Annual Load Profile

Contracted Baseload Generation

Contracted Combined Cycle

Contracted Peaking Plants

Owned Generation (Primarily Baseload)
Facing the Risks in Electricity Markets

Sources: Bureau of Labor Statistics (PPI indices; not seasonally adjusted) and SNL Financial (power and gas). Monthly prices/indices indexed to “100” at June 2003.
Generation is dispatched from least marginal cost to maximum

System Demand Establishes Clearing Price for Energy (FERC Tariff)

As Demand Increases, Prices Rise Accordingly

Hydro  Wind  Nuclear  Coal  Gas – CC  Gas – CT  Other
Typical Consumer Cost Increase Example

• New Jersey Basic Generation Service (BGS) Load Procurement
  • One third of New Jersey’s roughly 20,000MW of residential and small commercial load auctioned annually (laddered procurements used to smooth rate impacts)
  • Approximately 100M MWH of electricity delivered to New Jersey residential and small commercial customers annually
  • A $2/MWH increase in the bid-ask spread would cost New Jersey consumers $200M annually

• Electricity markets, such as the BGS auctions, are subject to stringent regulatory and transparency guidelines
  • State utility commissions, such as the New Jersey Board of Public Utilities (BPU), monitor all generation bids in the BGS auctions to insure no market manipulation takes place and customers pay the lowest price for their energy needs.
  • FERC monitors all physical power contracts executed under market-based rate authority through its Electronic Quarterly Reporting rules. This ensures that wholesale power rates are just and reasonable.
Impact of OTC reform on Constellation Business Units and Customers

1. Potential designation of Constellation as a Swap dealer or MSP

   - Constellation uses the OTC and exchange markets in both custom and standard products for risk management and price discovery to support:
     - Constellation hedging activity for both customer supply, generation
     - Constellation new client/project origination in energy, renewables, capacity, and fuels
     - Constellation pricing for customized retail and wholesale energy solutions
   
   - Designation as a swaps dealer or MSP would increase the cost to Constellation and its customers through 1) loss of unsecured credit lines, 2) higher initial and variation margin requirements, 3) forced clearing, and 4) increased capital requirements leading to potential credit downgrades, increased borrowing costs. Results in higher prices to wholesale and retail customers and less capital devoted to development of renewable resources, energy efficiency, and new generation.

2. Potential designation of FERC jurisdictional products such as Financial Transmission Rights (FTRs) and virtual bids as swaps would subject Constellation to duplicative regulations and possible double margin requirement from both the ISO/RTO and the CFTC required margin for cleared and non-cleared swaps.

   - Increases the cost of service, deliverability risk, and reliability to customers in organized markets primarily in the upper Midwest and Northeast
   
   - Places these ISO and RTO products under a dual jurisdiction of FERC and the CFTC with little gain in financial assurance since RTO and ISO already have Financial Assurance Provisions in their FERC approved Tariff for these products.
Key Issue Identification/Proposed Resolution

Definition of a Swap Dealer and Major Swap Participant:

SWAP DEALER.—
(A) The term ‘swap dealer’ means any person who, as its principal business – (i) holds itself out as a dealer in swaps; or (ii) acts as a dealer or market-maker in swaps;

(B) EXCEPTION.—The term ‘swap dealer’ does not include any person who, as its primary business activity, owns, uses, produces, processes, manufactures, distributes, merchandizes or markets a physical commodity and enters swap transactions for purposes of hedging, managing or otherwise mitigating the risks related to such person’s principal business.

MAJOR SWAP PARTICIPANT.—
(A) IN GENERAL.—The term ‘major swap participant’ means any person who is not a swap dealer and who maintains a substantial net position in outstanding swaps, excluding:

   (i) any person who, as its primary business activity, owns, uses, produces, processes, manufactures, distributes, merchandizes or markets a physical commodity; and

   (ii) any person that satisfies the requirements for any other exemption that the Commission may promulgate upon finding that such exemption is in the public interest.

(B) DEFINITION OF SUBSTANTIAL NET POSITION.—The Commission shall define by rule or regulation the term ‘substantial net position’ at a threshold that the Commission determines prudent for the effective monitoring, management and oversight of entities which are systemically important and can significantly impact the financial system.

SWAP.—

“Swap” should exclude:
“any sale of a nonfinancial commodity for deferred shipment or delivery, so long as the transaction contains an enforceable delivery obligation.”
Key Issue Identification/Proposed Resolution

Presumption of Clearing

- Proposed legislation would require any swap accepted for clearing by a Designated Clearing Organization to be cleared. This presumption introduces several unintended consequences:
  - A moral hazard for DCO’s to maximize revenues by clearing all transactions regardless of standardization or valuation
  - A “race to the bottom” as competing exchanges reduce collateral requirements, increase position limits, or otherwise minimize transaction costs/compliance requirements
  - Transaction costs to commercial end-users will increase dramatically due to 1) loss of existing unsecured credit lines, 2) requirement to post initial margin to secure trade on exchanges, 3) ongoing requirements for variation margin twice daily, 4) potential incremental margin to Regional Transmission Organization due to loss of offsetting physical generation

Exclusion of FERC Regulated/Approved RTO Products and Services:

Proposed Statutory Language

1. No provision of this Act shall apply to any agreement, contract, transaction, product, market mechanism or service offered or provided pursuant to a regional transmission organization or independent system operator tariff accepted by the FERC, or in the case of the Electric Reliability Council of Texas, accepted by the Public Utility Commission of Texas.

2. Furthermore, the CFTC and the FERC coordinate their activities with respect to protecting against market manipulation on matters that implicate the respective regulatory interests of each.
Commodity Market Among the Smallest Sub-Segments of Global OTC Market

Size of Global Market: $592 Trillion

Overview

- **Size**: $592 trillion notional amount / $34 trillion gross market value
- **Largest Sub-Segments**: interest rate (71% of market), FX (8%), CDS (7%), equity-linked (1%) and commodities (1%)
- **Market Growth**: Unprecedented growth over last 10 years (CAGR > 20% since 1998)

Global OTC Derivatives Market (Notional Amount)

Global OTC Derivatives Market (Gross Market Values)

Source Data: Bank of International Settlements