

WRITTEN TESTIMONY OF
ICE FUTURES US
BEFORE THE SENATE
COMMITTEE ON BUSINESS AND COMMERCE
TEXAS SENATE

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Introduction

Chair Hancock and the members of the Senate Committee on Business and Commerce, ICE Futures US very much appreciates the opportunity to submit this written testimony on the financial impacts of Winter Storm Uri over February 14, 2021 to February 19, 2021. At the outset, it is important to note that consumers in Texas have enjoyed some of the lowest cost electricity in the nation, in large part due to a competitive market environment giving consumers the power to choose their electric providers and encouraging power generators to compete for the right to put electricity on the grid. Core to that market is Texas providers and generators ability to mitigate the consumer price risk by utilizing market hedging tools.

Background

ICE Futures US can trace its history to the founding of the New York Cotton Exchange in 1870. Over the past 150 years, the exchange has grown to one of the largest US futures exchanges and lists North American energy contracts (power, natural gas, natural gas liquids, crude oil), US environmental contracts, financial contracts such as the US dollar index, metals, foreign exchange and agricultural contracts such as cotton, coffee, cocoa and sugar. ICE Futures US is regulated by the Commodity Futures Trading Commission as a Designated Contract Market. Our role in this discussion is tied to the market we provide for participants to hedge price risk.

Regarding the cold weather outages over February 15, 2021 to February 19, 2021, ICE Futures US lists futures contracts that financially settle to the locational marginal pricing (LMP) of electricity set by the Electricity Reliability Council of Texas (ERCOT). Because our contracts settle to the ERCOT LMP--for the market to work properly the financial contract must converge with the LMP. ICE Futures US created the ERCOT electricity futures contracts in the early 2000s to add transparency and financial stability to markets that were previously bilateral and opaque. Importantly, ICE Futures US offers clearing for ERCOT markets which provides risk mitigation and transparency for market participants and therefore help keep electricity prices low for Texas residents and industries. Market participants, particularly energy companies, use the ERCOT markets to hedge risk, usually hedging their physical ERCOT exposure with a financial contract. Again, the benefits of the transparency and risk mitigation of the ICE Futures US ERCOT markets result in lower prices for Texas consumers and increased investment by an increased number of parties.

The Cold Weather Outage

On February 14, ERCOT issued an emergency order in response to unprecedented cold weather. The order placed the price of electricity in Texas at \$9,000 a megawatt hour until the morning of February 19. Setting the price at \$9,000 gave a signal to Texas energy companies to take any action necessary to keep the lights on. Energy companies that hedged the electricity price exposure with daily and monthly financial contracts were then able to procure fuel at higher prices or find substitutes to provide electricity, again at higher prices, with less direct financial impact, believing those final contract prices will converge to the ERCOT LMP. Over that week, ICE Futures US' clearinghouse collected margin payments to manage risk in the ERCOT markets. While margin payments were large, the ICE Futures US ERCOT contracts settled and cleared without incident and no market participants defaulted on their payments.

However, over the past week, there have been calls to reprice the ERCOT LMP, either for a day or series of days over the outage week. ICE Futures US believes any such repricing would be a mistake for the reasons outlined below.

Importance of Transparent Reliable Markets to Texas

As noted in the introduction, Texas consumers enjoy transparent, efficient markets resulting in arguably the lowest cost of energy in North America. Texas' rapid growth and its ability to attract companies from other states, specifically energy intensive industries such as manufacturing are proof that the energy market in Texas is good. ICE Futures US has 382 electricity markets in the US and in comparison, to others, we can see that the Texas energy market is, on par, well functioning. Critical to good markets is the reliability of pricing information. Market participants must have complete confidence the price will remain the price. Very rarely do governments get involved in price setting in the markets because the results are inevitably catastrophic. The reason is the transparent forward curve.

One of the greatest benefits of a futures market is answering the question of what is the price of a commodity in the future? We call this the forward curve and for energy markets the forward curve can help predict the price months or even years into the future. This is important for three reasons. First, energy companies use the forward curve to hedge price risk in the future. If a commodity is \$2 now and the forward curve prices a commodity at \$5 in the future then the energy company can hedge that \$3 of price risk into the future, effectively curtailing the impact of volatility of prices. This price certainty is passed along to consumers through more stable prices. Secondly, energy companies rely on the forward to curve to decide what to produce and where to invest in the future. If the forward curve signals the price is \$5 rising from \$2, then a company may decide to produce more of the commodity to meet demand. These prices are critical to the investment decisions of firms. Equally as important, energy firm financing is reliant on forward pricing. When a company takes out a loan, the bank will look closely at the forward price in its decision making. Finally, other firms rely on the forward curve for investing in Texas. For example, when a manufacturing plant decides to relocate to Texas, they will look at future energy costs and the best place to find that price is in a transparent futures market.

Why is government intervention catastrophic to the forward curve? When the government gets involved, the risk is that the involvement is unknowable-effectively there is no way to factor government intervention into the price.¹ Creating an unknowable event makes it impossible for market participants to price risk - such activity simply eliminates transparency. Importantly, this is a binary event--either the government will change the price or will not. Binary events are very hard to price into contracts and effectively destroy the forward curve. If the government gets involved once, such as in a once in a generation weather event, then in the future government intervention can no longer be discounted and the markets will never be the same. The Rubicon will have been crossed, at least in the eyes of ERCOT market participants and investors. Intervention will also find support in any market where the supply or demand feel or experience “unfair” behavior. Texas will be required to cure this lack of fairness by making arbitrary decisions related to price and further damaging the confidence of doing business in Texas.

Repricing the ERCOT Markets May Further Damage Market Participants and Consumers

The ERCOT electricity market is only one piece of the Texas electricity market. When ERCOT set the price at \$9000 a megawatt hour, generators procured fuel from energy producers at higher costs--all to attempt to keep the lights on in Texas and to protect the grid. In addition, other electricity providers procured replacement electricity, again at the price determined by ERCOT. Energy companies then in turn used the ICE Futures US markets to hedge their price risk, again all determined by and relying on the ERCOT price.

Removing one domino by repricing ERCOT for the outage week will have cascading effects in other markets and may cause bigger problems than the repricing solves. For example, if a generator, as mentioned above, procured fuel justified by the ERCOT price, changing the price does not mean that the generator gets a rebate for the fuel it purchased. It stills owes money and will likely lose more if ERCOT is repriced. In addition, that generator might have hedged using ICE Futures US contracts based upon the ERCOT price. Changing these observed prices now destroys the value of any hedge. This is the slippery slope ICE Futures US is encouraging the State of Texas to avoid at all costs.

Conclusion

Earlier this week, Texas made the proud declaration it is open for business. The State of Texas is growing rapidly, attracting business from other states and other countries. Part of the reason Texas is successful is because it is business and market friendly. Texas has an inexpensive, transparent, and efficient energy market that underpins Texas economic growth. Government intervention by repricing ERCOT, especially after invoicing for the outage week has occurred will destroy the forward price curve and exponentially damage future investment in Texas. Without reliable market pricing, Texas consumers will inevitably be punished to solve the temporary problem from Winter Storm Uri and will absolutely pay more for energy for the future. In short, there are undeniable consequences of the winter storm to all Texas power market participants and

¹ ERCOT and other system operators occasionally reprice contracts based upon certain protocol reviews. By government intervention, we are referring to changes not based upon market dynamics.

consumers. However, there is no government price intervention that will not cause even more consequence.