



AMERICAN PUBLIC GAS ASSOCIATION

September 30, 2009

The Honorable Collin Peterson
Chairman
Committee on Agriculture
U.S. House of Representatives
Washington, D.C. 20515

Re: Proposed language on over-the-counter clearing

Dear Chairman Peterson:

I would like to follow-up on comments that were made during my testimony on behalf of the American Public Gas Association (“APGA”) before the House Agriculture Committee during its September 17th hearing to review proposed legislation by the U.S. Department of Treasury regarding the regulation of over-the-counter derivatives markets. I also request that this letter be incorporated as part of the hearing record.

During the hearing, I testified that proposals that would require all standardized OTC derivatives transactions to be cleared would significantly impair the financial ability of public natural gas systems to engage in the gas supply strategies described in my testimony. I further suggested that the exemption from mandatory clearing of over-the-counter (“OTC”) swaps provided in the proposed legislation by the U.S. Department of Treasury, the “Over-the-Counter Derivatives Markets Act of 2009,” (“Treasury Proposal”) should be clarified. You invited APGA to submit suggested clarifying language.

Section 713 of the Treasury Proposal as currently drafted requires the clearing of standardized swap contracts by a derivatives clearing organization except if no derivatives clearing organization will clear the transaction, or one of the counterparties is not a dealer or a “major swap participant and does not meet the eligibility qualifications of a derivatives clearing organization.” The Treasury Proposal defines a “major swap participant” as “any person who is not a swap dealer and who maintains a substantial net position in outstanding swaps, other than to create and maintain an effective hedge under generally accepted accounting principles, as the Commission and the Securities and Exchange Commission may further jointly define by rule or regulation.”

We believe that the intent of the proposed language is to exclude entities that enter into OTC swaps for hedging purposes from the definition of “major swap participant” and consequently from the requirement that their OTC transactions be required to be cleared. However, our members, who use the OTC derivatives markets on a routine and on-going basis to hedge their physical operations, are concerned that the Treasury Proposal’s grounding the exemption from mandatory clearing in an accounting standard may impede their flexibility in entering into hedging strategies by requiring that they tie particular swaps transactions to particular physical requirements and thereby introduce uncertainty into whether a particular transactions is exempt from the mandatory clearing requirement.¹

Moreover, the exemption as currently drafted is further conditioned on one of the counterparties to the swap not meeting the “eligibility requirements of any derivative clearing organization that clears the swap.” This provision is unclear in that the “eligibility requirement” is susceptible to multiple interpretations. It might be construed to mean eligibility standards to become a member or participant of the clearing house that clears the swap. However, although clearing members or participants generally set the requirements for establishing a customer account, the term “eligibility requirement” might possibly be construed as also meaning any entity that has access to the clearing services of the clearing house through a customer relationship with a member or participant of the clearing house. APGA believes that such a reading of the eligibility provision would be overbroad.

In order to clarify the exemption from mandatory clearing in the Treasury Proposal, APGA suggests the following language be substituted for Section 2(j)(8) as it appears in the Treasury Proposal:

(8) EXCEPTIONS—The requirements of subsection (j)(1) and (7) do not apply to a swap if—

“(A) no derivatives clearing organization registered under this Act will accept the swap for clearing;

“(B) one of the counterparties to the swap is a producer, processor, merchandiser, distributor or a manufacturer of, or user of, a commodity and enters the swap to reduce or manage risks in

¹ “To account for a derivative as a hedge, GAAP requires management at the inception of the hedge to designate the derivative as a hedge and contemporaneously formally document the hedging relationship, the entity’s risk management objective and strategy for undertaking the hedge, and the method of assessing the effectiveness of the hedge. In addition, to qualify for hedge accounting, GAAP requires that management have an expectation, both at the inception of the hedge and on an ongoing basis, that the hedging relationship will be highly effective in achieving the hedging strategy.” See, “SAS No. 92 — Auditing Derivatives and Securities,”

http://www.aicpa.org/members/div/auditstd/opinion/jul00_1.htm.

connection with the conduct or management of its commercial enterprise; or

“(C) one of the counterparties to the swap—
“(i) is not a swap dealer or major swap participant; and
“(ii) does not meet the eligibility requirements to be a member or participant of any derivatives clearing organization that clears the swap.”.

During the course of the hearing, you further asked whether APGA would share with the Committee its members’ thoughts on a number of issues; including 1) the potential cost to them if clearing is made mandatory; 2) whether exempting hedgers from mandatory clearing would result in concentrating risk at the dealer level, and how to avoid systemic risk from arising that concentration; and 3) whether credit facilities by the dealers themselves or different lenders would take the place of the current credit arrangements at reasonable prices to end-users.

First, please be assured that APGA’s members understand that the current swap transactions in which they transact include both a risk-shifting and a credit component. Our members understand that such transactions are structured to price both services, and to provide both functions, within a single transaction. Accordingly, our members understand that when entering into a swaps transaction with a dealer, there is an implicit charge related to the credit arrangement. However, our members, which are high-quality credit risks, believe that clearing-house style margin would make their swaps more expensive when added to the cost of each OTC transaction.

Clearing acts as a means of credit enhancement for lower-quality credit risks. In a cleared transaction all counterparties are treated as equal credit risks, thus a performance bond and daily margining is required. This is a necessary feature for contracts that are standardized with respect to all terms but price and in which the ultimate customer is not known to the clearing-house. In contrast, OTC agreements are bi-lateral agreements between known counterparties that have the time to perform credit evaluations and structure agreements that take into account all positive and negative attributes of both parties. Current bi-lateral credit arrangements recognize and take into account the available credit capacity of the counterparties via collateral thresholds that serve as a buffer before cash collateral is required. This results in recognizing the ability of particular counterparties to pay for the OTC transaction and lowers the cost accordingly.

Even if the ultimate economic cost of mandatory submission of OTC transactions to a clearing house were the same as the implicit credit cost of non-cleared transactions, it is critical to recognize that the financing arrangements between the two will be significantly different, with dramatically different results for our members. It is this difference which will make hedging cleared transactions far more difficult, if not impossible, for our members compared to the current credit arrangements that are integral to bi-lateral OTC transactions.

As hedgers, with very high credit ratings, assured collections from rate payers, and substantial assets in physical infrastructure, public natural gas systems under current practice in the bi-lateral swaps market often are not required to pledge collateral for transactions below agreed upon threshold levels. Moreover, adjustments to collateral levels are made on a pre-defined, periodic basis. This is particularly suitable to the routine funding and fee collection practices of public natural gas distribution systems. The customers of public gas systems reap the benefits of these credit arrangements which enable our members to hedge their natural gas purchases through lower rates for the natural gas which they purchase.

In this regard, it has been suggested that the clearing requirements would be less burdensome if end-users are given the option of posting non-cash collateral. In addition, in his testimony before this Committee, CFTC Chairman Gensler suggests that enabling clearing members to “have the ability to enter into individualized credit arrangements with end-users . . . to satisfy [their] margin obligations,” would enable mandated clearing concurrently with “appropriate, individualized credit terms with a clearing member.”² Unfortunately, neither of these fixes will make centrally-cleared transactions any more attractive or available to our members.

The alternative of using non-cash collateral would not provide meaningful relief to public natural gas systems. Public natural gas systems generally are prohibited by their constitutional documents from pledging as collateral the components of their physical infrastructure, such as pipelines. And using non-cash collateral in the form of short term highly liquid debt instruments provides no meaningful benefit from using cash itself.

Moreover, borrowing margin from their swaps dealer or from a third party is not an answer. The municipalities, special taxing districts and other authorities that operate public gas distribution systems are likely to be limited in their ability to borrow funds for the purpose of margining their hedging contracts. Even if they are permitted to borrow funds for this purpose, doing so might consume a municipality’s or public gas distribution system’s credit lines which are necessary for the operation of its general governmental obligations. Finally, in addition to the costs of establishing lines of credit or other forms of credit facilities, entering into such loan agreements may result in the downgrading of the municipality’s or taxing authority’s credit rating, a result which increases its general cost of funds for all of its *bona fide* governmental obligations, such as building schools, hospitals, roads and other infrastructure.

The alternative is for such public natural gas distribution systems to maintain large reserves of liquid funds to deposit as initial margin and to respond to margin calls

² See “To Review Proposed Legislation by the U.S. Department of Treasury,” Before the U.S. House Agriculture Committee, 111th Cong. 1st Sess. (2009) (Statement of Gary Gensler, Chairman Commodity Futures Trading Commission) at p 4.

whenever they arise. However, maintaining such large reserve funds is contrary to the rate-structure and collection policies of most public gas systems.³

Finally, many public natural gas systems are run with very lean staffs. The necessity of making frequent margin payments that are often a hallmark of centralized clearing that uses a daily mark-to-market system of risk management would strain many of those systems operationally when compared to the fixed periodic true-ups associated with OTC credit arrangements. Accordingly, as we have testified before this Committee, mandated clearing is likely to act as a significant deterrent to many of our members continuing to use these markets to hedge their risks, ultimately to the detriment of their customers.

In a follow-up question, you asked whether permitting end-users to continue to engage in bi-lateral transactions would concentrate risk at the dealer level and so contribute to systemic risk. We do not believe that this is the case. The size of the positions, velocity of trading and leverage employed by our members is naturally limited by the fact that they use these contracts only for hedging purposes. Although the failure of any one of these systems due to poorly managed trading would be a significant blow to their local communities, none is too large to fail. Nor are these entities interconnected in such a way as to pose a systemic risk. Even were all of the public systems to trade with a single dealer, which they do not, we do not believe that their activities would result in undue concentrations of risk. Accordingly, despite the fact that our members do not contribute in any meaningful way to systemic risk through their bi-lateral transactions, some have suggested that they nevertheless be subject to mandated clearing of those transactions regardless of the undue burden such a requirement would impose upon them.

To the extent that systemic risk is associated with these bi-lateral transactions, it arises in connection with the business conduct of the swaps dealer and whether, as a result of the dealer's overall business activities, the dealer poses a risk to the financial system due to either its size or inter-connections. One way to address such systemic concerns (as the Treasury Proposal currently provides) is to require centralized clearing with respect to contracts between *dealers* or between a dealer and another systemically significant counterparty. This would mutualize the risk of the parties that actually pose risk to the system. However, the risk to a particular dealer from its non-systemically

³ The amount of reserves necessary for a public gas distribution system to meet these margin requirements may be significant. One APGA member from the mountain West has estimated that the impact of such a change in financial requirements would cause a substantial increase in its need for cash and liquidity well beyond normal levels. This prospective increased need for capital, based on existing hedge policy requirements, to fund initial and variation clearing-house-style margins could exceed \$100 million. This amount is at least 50% greater than the current cash and liquidity needed by the utility. This large cash requirement would need to be collected directly from customers through significant rate adjustments during an economic downturn and at a time when there is already tremendous pressure from regulatory costs. In addition, reduced system infrastructure investment and increased borrowing costs would occur as a result of this requirement. A substantial rate increase to provide cash held for potential margining will extract community income needed to fuel the growth of its local economy. Given these costs of funding a new margining requirement, this utility may seriously consider discontinuing its hedge program if mandatory clearing of such transactions is enacted.

significant counterparties, such as APGA's members, can be adequately addressed by effective and meaningful capital requirements that apply to the dealer. These capital requirements would require that the dealer maintain adequate reserves or capital to cover potential losses on the risks of the positions that the dealer undertakes with not-systemically-important end-users or in connection with non-standardized transactions.⁴

Finally, during the hearing several witnesses stated that clearing is necessary in order to provide transparency to the market, with the consequent result of tightening bid/ask spreads, implying that all end-users would benefit from mandated clearing. APGA supports greater transparency for OTC markets and has been a proponent of greater transparency for a number of years preceding the recent financial crises. Nevertheless, it is important to recognize that greater transparency can be achieved in myriad ways and is not necessarily tied to mandatory clearing. Indeed, OTC contracts that are currently traded on the Intercontinental Exchange, Inc., are traded in a multilateral, transparent environment but may be either cleared or non-cleared. Thus, it is important in considering these critically important matters to separate issues of market transparency from systemic risk. APGA believes that we can have transparent markets with tight bid/ask spreads and still maintain the benefits of current bi-lateral credit arrangements.

APGA thanks you for the opportunity to submit our suggested language for the Committee's consideration and for the opportunity to respond to your questions.

Sincerely,



Dave Schryver
Executive Vice President

⁴ In this regard, it should be noted that even with respect to a traditional Derivative Clearing Organization regulated by the CFTC, the clearing house guarantee only covers the counterparty risk of the other clearing members or participants from the default of a clearing member or participant. The clearing house does not guarantee the relationship between a particular clearing member or participant and its customers. This risk is addressed in the regulated futures market through net capital requirements and the segregation of customer funds.