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COMMENT

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COMMODITY FUTURES
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Ms. Brooksly Born, Chairperson
Commodity Futures Trading Commission
1155 21st Street, N. W.
Washington, D.C. 20581

Dear Ms. Born:

As a member of the Board of Directors of the New York Mercantile Exchange I enjoyed your recent presentation to us. At that meeting you indicated that the CFTC was in the process of reviewing changes to existing rules. During the question and answer part of the meeting, I asked you specifically about rules regarding "eligible swap participants". I believe that as written, the rules eliminate a large number of individuals in the oil and gas markets who could benefit from price risk management tools currently provided by the OTC market. Detailed below is an articulation of the opportunity as I see it:

Statement of Issue:
In the physical energy markets the development of both crude and natural gas wells are highly dependent upon private investors who risk capital to become a non-operating working interest ("owner") in individual producing properties. Each owner receives a percentage of the revenue from the sale of the well's production. However, as a group, the royalty owners of each well give the well operator the rights to market the production on their behalf. With this obligation, the well operator will almost never offer price protection – the opportunity to purchase a price floor limiting exposure to falling prices – to the owners as a group because not all owners would necessarily want to participate. However, the operator, who usually does qualify as an eligible swaps participant will frequently protect his limited interest of often 20% or less, while owners who jointly control the bulk of production are subject to the vagaries of the oil markets.

Under current circumstances, the tens of thousands of owners who own millions of barrels of oil and gas produced per day do not have adequate opportunity to hedge their price risk.

Why existing price risk management tools are ineffective for the average owner:

As stated above the average owner plays the role of a passive investor and as such is not an eligible swap participant. Thus, the average owner can not purchase the customized price protection instruments which are readily available in the market place to other participants. Exchange traded instruments are seldom effective for an owner for the following reasons:

- Volumes do not match: NYMEX contracts are traded in 1,000 barrel increments. Few owners control production in exactly 1,000 barrel increments. Thus a hedge with an exchange-traded instrument will be inefficient because an owner can not hedge in the same volumes that he produces. For an owner to construct an efficient hedge with a NYMEX instrument he would have to control a minimum of 30,000 barrels per month. The volume of 1,000 barrels per day would give him the ability to hedge in the same time periods his crude is being sold.
- Types and locations of crude do not match: NYMEX crude is West Texas Intermediate, a sweet crude deliverable at Cushing, Oklahoma. Less than half of all domestic crude qualifies as sweet (less than .05% sulfur) and very little production is actually at Cushing, Oklahoma. The differential between NYMEX deliverable crude and other grades and locations is known as basis differential. The market swings in price for various crude grades and locations can vary as much as outright price changes in NYMEX crude. An owner who hedges with a NYMEX contract may find that the NYMEX price increased while the value of his crude decreased. Thus, a hedge with a NYMEX could be twice as inefficient as doing nothing.
- Only an average price option will protect a owner – NYMEX options (American style, not Average Price) do not offer effective protection: NYMEX options convert to futures, if they do not expire worthless, on average three days prior to the last futures trading day for oil and on the second to last day of futures trading for natural gas. As such these options provide an inefficient hedge for an owner who is receiving an average of prices over the calendar month. The owner needs an average price option, not the American style option the NYMEX offers.

OTC Market Offers Better Price Risk Management Alternatives:

- OTC market makers can act as aggregators for owners who need small and odd lot protection. This market aggregator function can provide individual royalty owners with price protection they can not create for themselves at any price.
- OTC market makers, particularly those of us who are actively involved in the physical markets can and will provide grade, basis and location adjustments for the diverse mix of crudes and natural gas produced in North America. This will create a more efficient hedge mechanism for an owner of sour crude in Louisiana versus an inefficient hedge based upon a different grade of crude sold in a different location.
- OTC market makers can create average price options which mirror the pricing mechanisms of physical crudes.

Request for Change:
Allow qualified OTC market makers to provide needed price risk management tools to owners:

- In essence an OTC market maker can serve a unique niche for oil and gas owners by creating custom made price protection instruments for specific markets, grades and volumes. These individuals and family trusts have a unique exposure to price risk in one of the most volatile commodities traded. Owners should be allowed to use the same risk reducing opportunities which larger investors in oil and gas routinely use.

I believe that this is a very beneficial and timely change to make to the rules governing eligible swap participants. I look forward to your comments.

Sincerely,

Thomas Costantino
Vice President Domestic Crude Trading and Risk Management
Unocal Corporation

Member of the Board of Directors
New York Mercantile Exchange