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October 9, 1998

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

COMMENT

Re: Over-the-Counter Derivatives Concept Release

Dear Ms. Webb:

On behalf of BP America, Inc., Enron Capital & Trade Resources Corp., J. Aron & Company, Koch Industries, Inc., Mobil Business Resources Corporation, Phibro Inc. and Sempra Energy Trading Corp. (the "Energy Group"), we are pleased to comment on the Commission's Concept Release on Over-the-Counter Derivatives ("OTC"), 63 Fed. Reg. 26,114 (May 12, 1998) (the "Concept Release"). The Energy Group together with its affiliates consists of oil and gas producers, refiners, processors and marketers, as well as electric utilities and marketers of electricity. Members of the Energy Group are engaged in a full range of OTC energy derivatives transactions including swaps and hybrid instruments as dealers, market-makers and end-users. Members of the Energy Group may be commenting individually on the Commission's release.

As a Group, we are concerned that the issuance of the Concept Release, and any actions taken by the Commission to implement the types of regulation contemplated by the Concept Release, will serve only to severely disrupt the OTC market and in turn will undermine the critical risk management services that the OTC derivatives markets provide to the energy industry and to consumers of energy. We therefore support, rather than any further action by the Commission, a study of the issues raised in the Concept Release by the President's Working Group on Financial Markets and by the U.S. Congress in the context of the upcoming Commission reauthorization.

A Commission proposed rule regulating - - rather than exempting - - swaps and hybrids in the OTC market would, in itself, create immediate legal uncertainty about the validity of existing and new contracts. In particular, because the Commission only has jurisdiction to regulate those instruments that are futures contracts or commodity options, any regulation by the Commission of OTC derivatives will create the implication that such instruments may be futures contracts or commodity options, thereby raising questions as to their enforceability. At a minimum, regulation would stifle the industry's ability to develop new products to respond to changes in the marketplace and client needs. Most likely this uncertainty would compel many providers of risk management tools in the energy industry to withdraw from the domestic market or to severely limit the products they are willing to offer. As a result, farmers, energy producers and consumers, and other users of derivative products would be required to pay more or would be unable to use those tools to control their exposure to energy and commodity prices.

The concern of the Energy Group is that the recent Commission Concept Release and related Commission statements undermine the goal of legal certainty that Congress directed the Commission to achieve in the 1992 Futures Trading Practices Act. A key element of that legislation was to provide the Commission with the authority, and to direct it, to explicitly exempt certain transactions from provisions of the Commodity Exchange Act that might otherwise make those transactions illegal and unenforceable. The exemptions eliminated any legal challenge to those transactions based on the claim that they are illegal, off-exchange futures contracts. The 1992 legislation was not a license for the Commission to develop a comprehensive regulatory structure for derivatives as the Concept Release outlines.

With the ongoing and expanding deregulation of the energy industry at the federal and state level, including, most recently, electricity, there is a growing, essential need for derivatives to manage these new risks. The broadly recognized benefit to consumers of free market pricing requires that merchandisers of energy products protect themselves from market price exposures. Risk management and trading have become key ingredients in all energy company businesses. The members of the Energy Group use derivatives for their own accounts and also provide hedging services to their customers either on a stand-alone basis or as part of the marketing of energy products. The derivatives are employed to address risks arising from, among other things, volatility in interest rates, foreign exchange rates and commodity prices. The importance of derivatives for the Energy Group companies and their customers cannot be overestimated. Commercial producers and users of energy, including utilities, refineries and marketers, cannot relocate offshore, unlike many other dealers and users of derivatives products. The success of this business can be completely undermined by new legal uncertainties or a costly regulatory regime that has no place in the energy industry.

OTC derivatives dealers, in order to meet the risk management needs of market participants, must have the flexibility to develop customized products tailored to satisfy such needs. A futures exchange-style regulatory scheme is oriented toward markets offering uniform products in a public environment through brokered transactions. Such a regime is ill-suited to the nature and needs of the OTC market and will deprive market participants of the necessary flexibility to design and enter into customized risk management products.

The regulatory regime contemplated by the Concept Release, therefore, rather than stimulating growth in the OTC market, will inhibit it by decreasing legal certainty and the confidence of dealers and users and will constructively exclude many market participants, thereby increasing costs, all in direct contradiction of the stated goals of the Concept Release. One need only look to the response to the Commission's enforcement investigation of certain energy swaps dealers and its issuance of an Advance Notice of Proposed Rulemaking in 1987. These developments created legal uncertainty concerning the status of certain swaps as futures contracts that may be subject to the Commodity Exchange Act. In response to these concerns, large segments of energy and other swap activity moved offshore, and some U.S. firms ceased development and use of derivatives entirely, thereby reducing the ability of U.S.-based energy companies to manage risk and inhibiting the growth of these activities in the U.S.

Current events raise similar concerns. The Commission's recent statement in a letter to the SEC that "OTC products include instruments that are forward contracts, futures contracts, option contracts, and swaps (many of which constitute futures or options") raises serious concerns about the legality of a broad range of derivatives transactions. Prior to that statement neither the Commission nor Congress had ever declared that any swaps are futures. The declaration to the SEC, combined with the Concept Release's outline of a comprehensive regulatory regime for swaps, raises serious concerns about the legal status of these important products. The press again is reporting that OTC derivatives activities are the subject of a Division of Enforcement investigation. In addition, the Commission's recent rulemaking on agricultural trade options is instructive. It presents an inefficient and costly regulatory regime that effectively prohibits these essential products. The need for agricultural trade options is motivated by the need to provide farmers with risk management tools in a deregulated agricultural environment. This same motivation for the efficient development of derivatives products applies to the energy industry. It should be no surprise that the Energy Group is gravely concerned that the agricultural trade options precedent presages a regulatory scheme for energy derivatives under the Concept Release that will only serve to inhibit if not effectively prohibit the development of these critical risk management tools.

Since 1993, when the Commission, at Congress' direction, adopted exemptions that provided substantial legal certainty for the markets, the derivatives business for energy companies has grown without significant problem or incident. We believe that the regulatory regime contemplated by the Concept Release is completely contrary to the objective of Congress to promote economic and financial innovation and fair competition. Moreover, it does precisely what the Commission in the Concept Release itself stated that it wished not to do - - that is impair "the ability of the OTC derivatives market to continue to grow and the ability of U.S. entities to remain competitive in the global financial marketplace." Therefore, we request that the Commission refrain from unilaterally attempting to regulate the over-the-counter derivatives market to ensure that this market continues to provide vital risk management services.

Accordingly, we support the efforts of the President's Working Group and Congress to develop a consistent response to changes in the marketplace without endangering the market's further development.

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The Energy Group appreciates the opportunity to comment upon the Concept Release. We of course stand ready to provide any further assistance which may be helpful to the Commission in its consideration of this matter.

Sincerely,

Energy Group

cc: BP America, Inc.
Enron Capital & Trade Resources Corp.
J. Aron & Company
Koch Industries, Inc.
Mobil Business Resources Corporation
Phibro Inc.
Sempra Energy Trading Corp.