Acceptance of Public Submissions on the Wall Street Reform and Consumer Protection Act and the Rulemakings That Will Be Proposed by the Commission

COMMENTS OF THE AMERICAN GAS ASSOCIATION

Pursuant to the Notice issued August 20, 2010,1 by the Commodity Futures Trading Commission (“CFTC” or “Commission”), the American Gas Association (“AGA”) respectfully submits these comments. The Commission’s rulemakings to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)2 should ensure that the financial markets related to energy commodities function efficiently and protect the ability of commercial hedgers to engage in risk management activities for the benefit of American energy consumers at reasonable cost. Gas utilities enter into a variety of financial transactions on behalf of themselves and their retail customers to mitigate the risk of volatility in the cost of providing natural gas service, including the cost of natural gas commodities. In these comments, AGA offers recommendations regarding the end-user exemption to assist the Commission in developing specific rules to implement the Dodd-Frank Act. In particular, AGA urges the Commission to limit collateral requirements for creditworthy end users, like gas utilities, and their counterparties.

I. COMMUNICATIONS

All pleadings, correspondence and other communications filed in this proceeding should be served on the following:

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II. IDENTITY AND INTERESTS

The AGA, founded in 1918, represents 195 local energy companies that deliver clean natural gas throughout the United States. There are more than 70 million residential, commercial and industrial natural gas customers in the U.S., of which 91 percent — more than 64 million customers — receive their gas from AGA members. AGA is an advocate for local natural gas utility companies and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international gas companies and industry associates. Today, natural gas meets almost one-fourth of the United States’ energy needs. AGA’s members engage in financial risk management transactions in markets regulated by the Commission. As such, AGA’s members will be directly affected by the Commission’s regulations promulgated under the Dodd-Frank Act.

III. COMMENTS

A. Background

AGA member companies provide natural gas service to retail customers under rates, terms and conditions that are regulated at the local level by a state commission or other regulatory authority with jurisdiction. Each year, natural gas utilities develop plans to reliably

3 For more information, please visit www.agag.org.
meet the gas supply needs of their retail customers. Gas utilities build and manage a portfolio of physical supply, storage and transportation services in order to meet anticipated demand. As such, gas utilities are commercial entities exposed to commodity risks, most especially the price of natural gas commodities. Gas utilities have a strong interest in managing these portfolios to ensure that the overall cost for natural gas service remains stable and at a reasonable cost to their customers. Price volatility presents significant challenges for both consumers and the gas utilities that serve them. Some gas utilities are required by state regulatory agencies to hedge a portion of forecasted demand to manage potential volatility.

In addition to their physical transactions activities, many gas utilities use a variety of financial tools, such as futures contracts traded on CFTC-regulated exchanges and over-the-counter energy derivatives, to hedge against volatility in natural gas commodity costs. In a recent survey, 90 percent of the AGA members responding to the survey indicated that they use financial instruments, including futures, options, and swaps, to hedge at least a portion of their gas supply purchases. Some gas utilities serve customers located far from major commodity trading hubs. Customized financial products may enable gas utilities to mitigate the volatility of natural gas commodity costs for those customers more effectively than standardized products linked to prices at a distant trading hub. In addition, some gas utilities are required by state regulations to allow retail customers to obtain commodity supplies from unregulated, retail marketers while continuing to be obligated to provide service to those who request it. Customized financial products can allow a gas utility to increase or decrease hedging quantities to mitigate risks as customers migrate to or from unregulated retail marketers. These commercial hedging activities aid in reducing price volatility to end-use customers.
In general, gas utilities forecast the anticipated demand on their systems and assess the underlying physical exposure associated with that demand. Many gas utilities then determine if financial instruments are needed to mitigate all or a portion of that exposure. The financial products are often futures contracts on CFTC-regulated exchanges that do not exceed in quantity the fixed-price sale of the same cash commodity or the unfilled anticipated requirements of the same cash commodity. Although a gas utility’s hedge positions may, on occasion, exceed the quantity required to hedge the underlying physical gas supplies associated with meeting the needs of their retail customers, these positions are often the result of forecasting error, \textit{i.e.}, the forecasted gas supply needs were greater than actual usage, or unanticipated migration of customer load to retail marketers reduced the supply that the utility needed to provide. Under those circumstances, the “over-hedged” gas utility is still hedging a commercial risk and not engaging in speculative activities.

Gas utilities reduce the cost or hedges for their customers by relying, in part, on their strong financial profiles to obtain unsecured credit for their hedging transactions instead of posting cash collateral. Typically, entities owning gas utilities maintain a capital structure that is approximately 50 percent equity and 50 percent debt, and own large quantities of tangible assets (\textit{i.e.}, gas distribution systems and other energy facilities) that are recorded on their books at historical cost and financed through long-term debt. Gas utilities recover their costs, including the commodity-related costs of providing service, from their retail customers through rates approved by their local regulators. The commodity-related costs are recovered close in time to when the costs are incurred, \textit{i.e.}, on a monthly basis. Moreover, to the extent customers do not pay their bills, utilities may be able to recover such costs through their rates either in the form of an expense included in base rates or through a monthly or quarterly cost recovery mechanism.
As a result of these strong credit profiles, gas utilities are able to negotiate with financial
counterparties to take hedging positions up to a specified limit without having to post margin or
collateral. Similarly, gas utilities often extend their counterparties a measure of unsecured credit
as part of their ISDA agreements, if justified by the counterparty’s financial profile. These
unsecured credit arrangements benefit consumers by enabling counterparties to offer hedges to
gas utilities at lower cost.

Recently, some gas utilities have begun contracting with asset managers to assist with
several aspects of managing a utility’s portfolio. Under Asset Management Arrangements
(“AMAs”), the gas utility assigns all or a portion of its physical gas supply portfolio (e.g.,
commodity purchase rights, interstate pipeline transportation capacity, and storage capacity) to
an asset manager in exchange for compensation and a commitment from the asset manager to
physically deliver natural gas to the utility’s distribution system as needed. The asset manager
expects to earn a profit by marketing any physical commodity, transportation or storage rights
not needed by the gas utility during portions of the contract period. The Federal Energy
Regulatory Commission recently revised its rules to encourage the use of AMAs in the natural
gas industry.4 The central purpose and intent of these transactions is to facilitate the physical
delivery of natural gas, and thus AMAs are not financial transactions.

Against this background, AGA offers the following views on how the Commission
should implement the Dodd-Frank Act.

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37,058 (June 30, 2008), FERC Stats. & Regs., Regs. Preambles ¶ 31,271 (2008), order on reh’g,
31,284 (2008), aff’d sub nom. Interstate Natural Gas Ass’n of Amer. v. FERC, D.C. Cir. No. 09-
1016 (decided Aug. 13, 2010).
B. End-User Exemption

Under the Dodd-Frank Act, swaps must be cleared on a registered exchange or designated swap execution facility. This clearing requirement, however, does not apply if one of the counterparties to the swap: (1) is not a financial entity; (2) is using swaps to hedge or mitigate commercial risk; and (3) notifies the Commission how it generally meets its financial obligations associated with entering into non-cleared swaps. Congress created this provision as “a robust end user clearing exemption for those entities that are using swaps to hedge or mitigate commercial risk.” AGA believes that Congress intended to allow gas utilities to qualify for this end-user exemption, as their activities in the swaps markets are functionally equivalent to “energy companies who produce and distribute power,” which the Dodd-Lincoln Letter specifically identified as commercial end users. AGA urges the Commission to make certain clarifications to ensure that this commercial end-user exemption is indeed as robust as intended.

In order to qualify for the end-user exemption, one of the counterparties must not be a financial entity, which is defined to include swap dealers and major swap participants. In its September 20, 2010 comments on the key definitions in implementing the Dodd-Frank Act, AGA urged the Commission to ensure that natural gas distribution utilities are not considered “Swap Dealers” or “Major Swap Participants” as the Commission defines those terms. AGA further believes that the benefits accruing to an end user under the exemption should be

5 Dodd-Frank Act § 723 (1)(A).
6 Dodd-Frank Act § 723 (7)(A).
7 Letter from Senators Blanche Lincoln and Christopher Dodd, Chairs of the Senate Agriculture and Banking Committees, to Congressmen Barney Frank and Colin Peterson, Chairs of the House Financial Services and Agriculture Committee dated June 30, 2010 (“Dodd-Lincoln Letter”).
8 Id.
9 See Dodd-Frank Act § 723 (7)(C)(1).
preserved even when the end user enters into a financial transaction with a swap dealer or major
swap participant. In other words, an end user that is using swaps to hedge a commercial risk and
otherwise qualifies for the end-user exemption should not be subject to the clearing or margin
requirements solely by virtue of entering into a transaction with a swap dealer or major swap
participant. In addition, swap dealers and major swap participants entering into uncleared
transactions with creditworthy end users should not be penalized for doing so by having their
capital or margin requirements increased. The cost of those requirements would be passed on to
end users, including gas utilities, and ultimately to their customers.

The Dodd-Frank Act requires the end user to be using swaps to hedge or mitigate
commercial risk in order to obtain the exemption. AGA urges the Commission to further define
or explain the activities that would be considered “hedg[ing] or mitigat[ing] commercial risk.”
For gas utilities, such activities should clearly include entering into swaps to hedge against price
exposure. As explained above, gas utilities enter into financial transactions to manage price risks
associated with natural gas service, including the cost of natural gas commodities, as a function
of their commercial businesses.11

Further, the Commission should define or explain what documentation is necessary to
establish that an end user is hedging or mitigating commercial risk. Currently, Commission-
regulated exchanges have processes in place whereby an entity can obtain an exemption from an
exchange-established position limit on the grounds that the entity is a bona-fide hedger. Such
processes generally require the entity to describe the underlying physical position for which the
hedge is being sought. AGA recommends that the Commission review these processes and not

11 AGA endorses the definition of “commercial risk” proposed by the Edison Electric Institute in
its comments dated September 20, 2010.
impose any documentation requirements that are more burdensome or onerous than existing processes.

Under the end-user exemption, an entity is also required to notify the Commission how it generally meets its financial obligations associated with entering into non-cleared swaps. AGA recommends that the Commission limit the scope and frequency of this reporting obligation. In particular, any such notification should not be required on more than an annual basis. Also, this requirement may be coupled with that above and allow an entity to demonstrate both that the transaction is mitigating a commercial risk and that the entity has the wherewithal to cover the hedged position. In that regard, audited financial statements should be sufficient to meet the Commission’s needs.

The Dodd-Frank Act also requires the Commission (or a prudential regulator, if applicable) to permit the use of noncash collateral when establishing the capital and margin requirements of swap dealers and major swap participants consistent with preserving the financial integrity of swaps markets and the stability of the U.S. financial system. The Dodd-Lincoln Letter explained that Congress specifically mandated that regulators permit the use of noncash collateral because “individualized credit arrangements worked out between counterparties in a bilateral transaction can be important components of business risk management.” The Dodd-Frank Act left to the Commission and prudential regulators to determine the types of noncash collateral that would be consistent with preserving the financial integrity of swaps markets and the stability of the U.S. financial system.

AGA contends that gas utilities should be permitted to use unsecured credit as “noncash collateral.” As described above, many gas utilities rely on their strong credit profiles to use

12 See Dodd-Frank Act § 731 (adding new § 4s(e)(3)(C) to the Commodity Exchange Act).
13 Dodd-Lincoln Letter at p. 2.
unsecured credit for their hedging transactions instead of cash collateral. Based on their relatively high-equity capital structures, ownership of long-term assets, and cost-recovery mechanisms, gas utilities are able to negotiate with financial counterparties to take hedging positions up to a specified limit without having to post margin or collateral. The Commission should therefore permit such gas utilities to continue to be able to enter into swap transactions using their unsecured credit as noncash collateral. In that regard, although the Dodd-Frank Act suggests that the counterparty risk associated with the use of uncleared swaps is greater, the Commission should recognize that the counterparty risk associated with the use of swaps by gas utilities is relatively low. As described above, gas utilities tend to be creditworthy and generally pose a low risk as counterparties. Where the counterparties of gas utilities have similarly strong financial profiles, they should also be permitted to rely upon unsecured credit in connection with their transactions with end users. This will enable them to offer hedges at lower cost, and, thus, benefit gas utilities and their customers.

14 See Dodd-Frank Act§ 731 (adding new § 4s(e)(3)(A) to the Commodity Exchange Act).
IV. CONCLUSION

Wherefore, for the reasons stated above, the American Gas Association respectfully requests that the Commission consider these comments in the appropriate rulemaking proceedings.

Respectfully submitted,

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