Natural Gas Supply Association

September 28, 2010

Mr. David Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Subject: Pre-Proposal Comments on OTC Derivatives Rulemakings Regarding Subject Areas II, V, VIII and XXVI

Dear Mr. Stawick:

In response to the U.S. Commodity Futures Trading Commission ("CFTC" or "Commission") August 26, 2010, Notice of Acceptance of Public Submissions[1] , the Natural Gas Supply Association ("NGSA") submits the following comments. References made herein to the Commodity Exchange Act (the "CEA") refer to that statute as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act.")

Established in 1965, NGSA represents integrated and independent companies that produce and market approximately 40 percent of the natural gas consumed in the United States. Because of the potential for the Act to unnecessarily impede what is and has been a healthy and resilient natural gas market, NGSA was an active participant in shaping the Act during its passage and wishes to take an active role in the Act's successful implementation.

The United States natural gas market is a well-functioning, competitive market. Congressional changes, such as the passage of the Wellhead Decontrol Act of 1989[2] and regulatory reform implementing those changes (i.e., separating a competitive natural gas supply market from a regulated cost-based pipeline transportation sector) resulted in the liquid, modern wholesale natural gas market where prices are established by the competitive forces of supply and demand. In the July 2009 white paper titled *Price*

[1] Acceptance of Public Submissions on the Wall Street Reform and Consumer Protection Act and the Rulemakings that will be Proposed by the Commission, 75 Fed. Reg.52,512 (Aug. 26, 2010).
[2] Pub. L. 101-60, 103 Stat. 157 (1989).

Transparency in the U.S. Natural Gas Market, Dr. William Albrecht noted, "...the U.S. natural gas market, unlike any other natural gas market in the world is very competitive, liquid, transparent and efficient. Natural gas prices over the long-term reflect supply and demand, leading to efficient use of natural gas by all sectors of the economy."[3]

As such, there are no captive customers in the wholesale natural gas market. Competition exists not only among natural gas suppliers, but also from suppliers of alternative fuels, such as coal and fuel oil. Most participants in the natural gas market are large, sophisticated entities with the market expertise to forecast and hedge risk with respect to their physical natural gas positions and which possess strong balance sheets anchored by substantial physical assets. In addition, the natural gas industry is capital-intensive and requires long-term investments. Industry participants have long hedged the risks associated with these lengthy investment time horizons by using bilateral contracts.

The continuation of a robust, cost-effective bilateral market for hedging risk is essential to the health and continued growth of U.S. natural gas supplies. Congress recognized the importance of cost-effective financial instruments to end-users and other non-financial entities in passing the Act. The CFTC should implement regulations that reflect Congress's recognition of the importance of these, and should do so in a manner that does not impede the ability of financial markets to continue to serve as a cost effective risk mitigation tool that supports continued investment in energy and the economy.

NGSA members are in the business of producing and marketing natural gas in the United States. While NGSA members may enter into swaps, they do so primarily to hedge or mitigate commercial risk. Thus, NGSA members do not "deal" in or make markets in swaps as those terms are commonly understood. Due to some ambiguity in the Act, the statute does not confirm that commercial risk hedging activities of some NGSA members would not result in them being designated Swap Dealers or Major Swap Participants even though these members engage in swaps to hedge commercial risk or accomplish other permissible purposes. The continued health and development of the physical natural gas market hinges on the adoption of a regulatory framework that resolves this ambiguity. At a minimum regulations should be adopted that protect physical market participants from increased costs that would divert capital from productive uses - particularly where such diversion would not further the goal of protecting consumers.

In addition to resolution of the ambiguity regarding the definitions of the Swap Dealer and Major Swap Participant, rules regarding **four key issues** are critical to maintaining

[3] William P. Albrecht, Price Transparency in the U.S. Natural Gas Market at 2 (July 14, 2009) (white paper on file with NGSA).

the long-term health of the U.S. natural gas industry and the integrity of the Act's provisions aimed at addressing end-user concerns. The significance of these four issues to the health of the physical natural gas market is even more critical depending on how the Swap Dealer and Major Swap Participant definitions are decided. In that regard, NGSA urges the Commission to consider the following:

1. **Swap Dealer.** The *de minimis* exclusion within the Swap Dealer definition should be based on the percentage of an entity's swap transactions with customers relative to its total swap transactions (i.e., swap transactions with customers and counterparties) within the applicable swaps category.

2. **Capital & Margin Requirements for Non-Bank Swap Dealer.** Non-bank Swap Dealer capital and margin requirements should be based on an evaluation that recognizes differences among market participants that affect their overall risk profiles, including factors such as the presence of physical assets, the relative strength of their balance sheet and parent company support. Entities with low risk profiles should face lower capital and margin requirements than those that present greater risk.

3. **Review Process for Swaps Subject to Mandatory Clearing Requirements.** Within the statutory criteria, the liquidity test for the process of identifying swaps subject to mandatory clearing should be based on the full term of the swap agreement, rather than a portion of the term. If the liquidity test cannot be satisfied for the full term of the agreement, the swap must not be subject to mandatory clearing.

4. **Position Limits.** The bona fide hedging exemption with respect to position limits must be applied in a manner that avoids (1) rigid categorization of market participants that would limit business flexibility with respect to hedging commercial risk and (2) using hindsight to "second-guess" entities' attempts to hedge.

1. **Swap Dealer.** The *de minimis* exclusion within the Swap Dealer definition should be based on the percentage of an entity's swap transactions with customers relative to its total swap transactions (i.e., swap transactions with customers and counterparties) within the applicable swaps category.

Paraphrasing the CEA, section 1(a)(49)(A) defines the term "swap dealer" as any person who:

i. holds itself out as a dealer in swaps;
ii. makes a market in swaps;
iii. regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

iv. engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps . . . .

Congress provided a *de minimis* exception to the categorization of a Swap Dealer in section 1a(49)(D) of the CEA: "The Commission shall exempt from designation as a Swap Dealer an entity that engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers." Importantly, Congress made the exception applicable to those engaged in a *de minimis* quantity "of swap dealing in connection with transactions with or on behalf of its customers." CEA, section 1a(49)(D) narrows the Swap Dealer definition to include only entities where the majority (technically, more than a *de minimis* amount) of their swap transactions are with or on behalf of customers. Those entities regularly engaging in swaps, unless more than a *de minimis* amount represents swap dealing with customers, are exempt under CEA, section 1a(49)(D). Even if one of the other criteria arguably applies to an entity, if the swap activity with or on behalf of customers is *de minimis*, the entity is exempt. As stated above, the *de minimis* exclusion within the Swap Dealer definition should be based on the percentage of a Swap Dealer's swap transactions with customers relative to that Swap Dealer's total swap transactions within the applicable category.

NGSA members are in the physical natural gas business. While most engage in swaps, unlike a Swap Dealer, the majority of their swaps are with counterparties, not customers. Thus, the use of the term 'customer' in the *de minimis* exception is significant. It indicates that Congress sought to subject those swap dealers entering into transactions with or on behalf of customers to the new requirements imposed on swap dealers but sought to exclude those entities engaging swap transactions where swap transactions with customers reflect a relatively small portion of those entities' overall swap transactions.

NGSA recommends that the CFTC rely on the contractual agreements between transacting parties to determine whether those parties have a "customer" relationship. Given the sophistication of entities that engage in over-the-counter derivatives transactions,[4] the CFTC should adopt a presumption that parties to such transactions are not customers unless an agreement between those parties explicitly states that the parties intend their relationship to be a customer relationship. NGSA appreciates that this presumption could be used by a traditional swap dealer to evade being deemed a Swap Dealer under the Act, and suggests that the CFTC could adopt a threshold test within the *de minimis* exception to prevent such evasion. For example, the CFTC could adopt a presumption that entities that are bank holding companies and non-bank financial companies subject to regulation under Title I of the Act do not qualify for the *de minimis* exception.

[4] *See* Commodity Futures Trading Commission v. Zelener, 373 F. 3d 861 (7th Cir. 2004) (""Eligible contract participants" under the Commodity Exchange Act are the equivalent of 'accredited investors' in securities markets: wealthy persons who can look out for themselves directly or by hiring experts.").

2. **Capital & Margin Requirements for Non-Bank Swap Dealers.** Non-bank Swap Dealer capital and margin requirements should be based on an evaluation that recognizes differences among market participants that affect their overall risk profiles, including factors such as the presence of physical assets, the relative strength of their balance sheet and parent company support. Entities with low risk profiles should face lower capital and margin requirements than those that present greater risk.

Regulations implementing the Act's capital and margin requirements should be drafted consistent with the language of the statute and with congressional intent regarding mitigation of systemic risk and avoidance of unnecessarily tying up capital from beneficial forms of investment. As Senators Dodd and Lincoln stated in their letter to House leadership[5]:

> It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would . . . impair economic growth.

Regarding entities such as "energy companies who produce and distribute power" the Senators went on to state:

> These entities did not get us into this crisis and should not be punished for Wall Street's excesses. They help to finance jobs . . . .[6]

Regulations addressing the capital and margin requirements for non-bank Swap Dealers and Major Swap Participants will impact the level of working capital in the economy. To avoid unnecessarily tying up capital used for investment, NGSA urges the Commission to adopt regulations that recognize differences among market participant balance sheets and other factors that affect overall risk profile such as the nature of the entity's business, the presence of physical assets and, when applicable, parent company support. Where such differences exist, the CFTC's regulations should require significantly lower levels of capital and margin. Finally, the regulations should provide flexibility to non-bank Swap Dealers to recognize commercially acceptable forms of collateral.

This approach recognizes physical asset investment and strong balance sheets and avoids increasing the risk management costs of those entities that do not pose a

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[5] Letter from Sen. Christopher Dodd and Sen. Blanche Lincoln to Rep. Barney Frank and Rep. Colin Peterson 1 (June 30, 2010) (the "Dodd-Lincoln Letter")
[6] *Id.* at 2.

systemic risk. Absent such an approach, capital and margin requirements effectively will have a capital-draining effect on the economy.

3. **Review Process for Swaps Subject to Mandatory Clearing Requirements.** The liquidity test for identifying swaps subject to mandatory clearing should be based on the full term of the swap agreement, rather than a portion of the term. If the liquidity test cannot be satisfied for the full term of the agreement, the swap must not be subject to mandatory clearing.

Although Congress put clearing at the heart of the derivatives market reform in the Act, Congress also acknowledged that:

> ... clearing may not be suitable for every transaction or every counterparty. End users who hedge their risks may find it challenging to use standard derivative contracts to exactly match up their risks with counterparties willing to purchase their specific exposures. Standardized derivative contracts may not be suitable for every transaction.[7]

Such is the case in the natural gas industry, where many swaps, by virtue of their long terms, are customized and relatively illiquid. Yet those swaps are particularly important in supporting long-term infrastructure investments in production and pipeline capacity. As such, the Commission should ensure that, in its review of swaps and its rules regarding such review, it does not subject such customized, long-term swaps to the Act's mandatory clearing requirement.

Section 2(h)(2) of the CEA requires the Commission to (1) review, on an ongoing basis, swaps and classes of swaps to determine whether they should be required to be cleared, (2) review submissions from derivatives clearing-organizations regarding which such swaps they plan to accept for clearing, and (3) adopt rules for such review. In this regard, one of the considerations that the Act expressly requires the Commission to take into account in determining whether a swap or class of swaps should be required to be cleared is its "trading liquidity," i.e., the existence of markets where such swaps can be bought or sold with relative ease.[8]

In the natural gas market in which NGSA members participate, long-term swaps are often used to hedge long-term contracts in the physical commodity or physical transportation market. The long terms of such swaps often make them very illiquid—*i.e.,* almost no "market" exists with respect to such swaps other than the very limited ones between the particular pairs of entities transacting with each other on bilateral

[7] *Id.*

[8] *See* CEA § 2(h)(2)(D)(ii)

bases. By definition, such long-dated swaps are "customized," as opposed to "standardized," and thus represent the kind of swap that Congress did not intend to be subject to mandatory clearing by derivatives-clearing organizations.

Congress recognized that required clearing of such illiquid transactions would be extremely inefficient, considering the paucity of equivalent contracts with which they could be cleared, which would effectively "raise transaction costs where there is a substantial public interest in keeping such costs low (i.e., to provide consumers with stable, low prices, promote investment, and create jobs.)"[9] Along those same lines, forcing swap participants to break up customized swaps into standardized and customized components in order to centrally clear some portion lies outside the scope of the Act and would promise to increase transaction costs contrary to congressional intent. For these reasons, Congress has effectively provided for the exclusion of illiquid swaps from the mandatory clearing requirement. In its future review of such swaps and in its rulemakings with respect to such review, the Commission should ensure that contracts that are illiquid by virtue of their long terms should not be subjected to the Act's mandatory clearing requirement.

4. **Position Limits.** The bona fide hedging exemption with respect to position limits must be applied in a manner that avoids (1) rigid categorization of market participants that would limit business flexibility with respect to hedging commercial risk and (2) using hindsight to "second-guess" entities' hedging practices.

Section 4a(a) of the CEA requires the Commission to establish aggregate position limits across various kinds of contracts, including positions in swaps exclusive of "bona fide hedge" positions. As Congress has made clear, the Commission must implement this bona fide hedging exemption in a manner that does not impede companies from appropriately managing their risk. On April 26, 2010, the NGSA filed comments[10] on the Commission's Notice of Proposed Rulemaking regarding Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations.[11] In those comments, NGSA offered recommendations to the Commission's then current proposal. Among those recommendations was that the Commission avoid adopting "crowding out" provisions that limit diverse portfolio approaches and harm liquidity. As proposed by the Commission, the crowding out proposal would preclude those market participants that use hedge exemptions from holding speculative positions, which would materially and negatively impact the role of the bona fide hedge exemption. As the Commission prepares to implement the position limits provisions of the Act, NGSA incorporates its previous comments by reference and makes two additional points.

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[9] *Dodd-Lincoln Letter* at 2

[10] *See* attached NGSA comments (Apr. 26, 2010).

[11] 75 Fed. Reg. 4144 (Jan. 26, 2010).

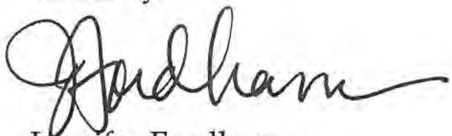
First, any modifications to the Commission's definition of "bona fide hedging transactions and positions" in section 1.3(z) of the Commission's regulations[12] must maintain or enhance the flexibility of that definition with respect to the countless manners of transactions and positions that entities might find necessary or useful in hedging risk. Therefore, the Commission must avoid establishing rigid classifications of the kinds of transactions and positions that qualify as bona fide hedges.

Second, in considering what positions are hedges, and what positions might be speculative, the exemption must be applied by the Commission using the forward-looking, situation-specific perspectives of individual swap participants. As an example from the natural gas market, consider a natural gas supplier hedging against predictions of a disruptive hurricane season in the Gulf of Mexico. In the event that the hurricane season is significantly less disruptive than predicted, the position the supplier took to hedge its perceived risk, as perceived at the time it entered into the subject transaction(s), should not be second-guessed in hindsight by the regulator as "speculation" on hurricane activity. Such second-guessing would effectively undermine swap participants' confidence in, and beneficial utilization of, the bona fide hedge exemption.

In summary, successful implementation of the Act to avoid harming investment in the U.S. natural gas market hinges on the rules surrounding these four key issues. The CFTC has the statutory authority to adopt rules that protect the U.S. financial system, but should do so in a manner that does not negatively impede continued robust investment in U.S. energy infrastructure or natural gas market liquidity.

NGSA stands ready to work with the Commission regarding these important issues concerning implementation of the Act. Please do not hesitate to contact us if we can provide any additional information.

Sincerely,



Jennifer Fordham
Vice President, Markets
Natural Gas Supply Association
1620 Eye Street, NW
Suite 700
Washington, DC 20006
Direct: 202-326-9317
Email: jfordham@ngsa.org

[12] 17 C.F.R. § 1.3(z) (2010).