NEWS

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NGSA.org, BlueJobs.org and NaturalGas.org

Changes to Financial Markets Could Severely Impact Natural Gas Customers, Warns Natural Gas Supply Association

-- Congress set to hold hearings --

(Washington, DC) Leaders in the U.S. House and Senate were cautioned today that proposed legislative changes to the over-the-counter (OTC) financial market could hurt the American economy, leading to a loss of financial liquidity, fewer jobs, increases in the cost of capital for energy companies, a reduction in natural gas supply, and consequent increasing costs to American consumers.

"Under many of these OTC regulatory proposals, instead of using our physical assets to establish credit, natural gas producers would have to redirect capital to meet exchange collateral requirements that could have otherwise been used for exploration and production or technological advances," said R. Skip Horvath, president and CEO of the Natural Gas Supply Association in a letter to Congressional leaders. "Raising capital requirements just to participate in the market will reduce the number of market participants, lowering liquidity and thereby increasing price volatility in the physical market."

On Thursday the Senate Agriculture Committee will review the OTC derivatives issue, which will be followed next Tuesday, June 9, in a hearing of the House Financial Services Securities Subcommittee.

In his letter, Horvath pointed out that the natural gas industry is a major player in the U.S. economy, employing approximately 4 million people, both directly and indirectly, and contributing approximately $400 billion annually to the nation's economic system.

He also noted that companies with strong credit and extensive assets with "steel in the ground" often enter into financial transactions with each other, using lines of credit which recognize core business, physical assets and creditworthiness, rather than cash collateral to secure the transaction.

"A requirement to move all OTC derivative transactions to an exchange has the same effect as mandating clearing, both of which require cash collateral," Horvath said. "To ensure the continued contribution of natural gas to the economy, consumers and the

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environment, Congress must avoid policies that increase capital costs and reduce liquidity in natural gas markets."

He pointed out that exchange trading and clearing requires standardized transactions which do not allow parties to tailor transactions to meet specific needs. "Companies who hedge do not all look alike," Horvath observed. "Hedging is often needed at unique locations simply because natural gas production is so geographically dispersed, and some companies have time horizons that do not fit standardized transaction durations."

He also said that limiting natural gas derivatives to standardized products would effectively prevent many companies, including some of the nation's 7,000 independent gas producers, from managing price volatility.

The full text of Horvath's letter is below….

June 17, 2009

The Honorable Harry Reid
United States Senate
Washington, D.C. 20510

The Honorable Nancy Pelosi
United States House of Representatives
Washington, D.C. 20515

Dear Majority Leader Reid and Speaker Pelosi:

While the Natural Gas Supply Association (NGSA) understands the consumer and Congressional interest in establishing a comprehensive regulatory framework for transactions in over-the-counter (OTC) derivative energy markets, many of the legislative proposals and policy recommendations generate a number of serious potential consequences to the natural gas market. One of which is the impact on market liquidity.

A reduction in energy market liquidity will lead to loss of jobs, increases in the cost of capital for energy companies, the reduction of physical natural gas supply and consequently an increase in energy costs to consumers. If financial reform legislation is enacted, Congress must pay careful attention to avoid harming the U.S. natural gas market.

NGSA represents the major integrated and independent companies that produce and market domestic natural gas. The natural gas industry employs four million people in the U.S. and contributes nearly $400 billion annually in value to the economy. Natural gas, the cleanest burning fossil fuel, is domestically produced, fuels more than 100,000 vehicles in the U.S., heats 60 million U.S. homes and is the source of about 25 percent of U.S. energy. Natural gas is used to generate 20 percent of U.S. electricity, is essential to continued reliability and occupies the least amount of land for the amount of electricity generated. Technological advances have reduced production footprints to one-tenth (1/10) the size of the 1970 production footprint making the continued health and viability of the U.S. natural gas industry critically important to clean energy solutions, consumers and the economy.

In an effort to assist in the balance between the Congressional and Administration interest in increased regulation of the derivatives market and the need for a liquid energy market, NGSA offers the following recommendations for your consideration in response to Secretary Geithner's proposal:

1. The clearing of OTC derivative natural gas transactions should remain voluntary, thus allowing OTC natural gas transactions to be traded off regulated exchanges.
2. Position limit exemptions for bona fide hedging transactions should remain available for market participants hedging energy commodity risk and not be limited to only those market participants holding physical assets or hedging risk tied to transactions involving physical assets.
3. The ability to establish margin requirements must remain with the regulated exchanges, with regulatory oversight, to ensure that they are dynamic and reflective of individual commodity markets.
4. Position and accountability limits should remain dynamic and the discretion to establish such limits should rest with the regulated exchange.

1. The clearing of OTC natural gas derivative transactions should remain voluntary, thus allowing OTC natural gas transactions to be traded off regulated exchanges.

NGSA does not support the mandatory clearing of OTC transactions. Requiring OTC derivative transactions to be moved to an exchange, which is another proposed concept, is essentially the same as mandating clearing in the OTC market because clearing is a characteristic of an exchange transaction. Mandatory OTC transaction clearing or moving all OTC transactions to a regulated exchange would limit customization capability and increase capital requirements, thus decreasing market participants and reducing liquidity.

Standardization

Currently, participants transacting in natural gas in the OTC energy markets are able to customize the products traded to meet varies types of needs and offset various types of risk. To illustrate, many natural gas producers, but not all, use the OTC market to offset natural gas price risk over the production time horizon. Production time horizons can be as short as a few years or as long as 50 years depending on the production area. Many natural gas producers have many natural gas wells, which may have different forms of production, each with different production characteristics and time horizons. Moreover, much natural gas production takes place at locations that are not liquid. Without liquidity derivatives cannot be exchanged traded or cleared. The requirement that OTC derivative transactions be cleared to regulated exchanges (or a centralized OTC clearing platform) will decrease the ability of many natural gas producers and other market participants to tailor products to meet specific needs since products traded on regulated exchanges or cleared products are standardized.

Customization allows many producers to tailor hedging activities to most efficiently match their specific and unique forecasted price risks. These needs vary substantially between producers due to the uniqueness of physical locations, production time horizons and other aspects of a producer's business. In fact, not all producers use financial hedging tools to manage risk.

It could be argued that the clearing requirement is necessary to mitigate counterparty credit exposure and credit risk in the energy market as a whole. However, as explained above, this perceived benefit needs to be balanced against any detriment to the energy market. NGSA is of the opinion that the benefit presented here would not outweigh the determent presented by the inability to customize hedging products.

Capital Requirements

When a transaction is cleared on an exchange or through a centralized OTC clearinghouse, collateral is posted. The collateral requirement is cash, or capital, and the level of capital required is based simply on the size of the transaction, irrespective of market participant's core business, physical assets or creditworthiness.

Some participants in the natural gas industry make extensive use of bilateral credit terms in OTC transactions. In doing so, parties with strong credit (often those with physical assets or "steel in the ground") enter into derivative transactions with each other, using lines of credit (which recognize core business, physical assets and creditworthiness), rather than cash collateral to secure the transaction. Thus, market participants with physical assets often do not need to post collateral because they are able to secure the transactions with the physical asset owned, produced and/or producing. The ability to secure credit with the physical asset allows the company to direct capital that may have otherwise been required to secure a transaction, into its core business which is producing and marketing energy, in our case, natural gas supplies. By forcing OTC transactions to an exchange or mandating clearing, we eliminate the ability of the financial market to recognize a physical asset as collateral, arguably disadvantaging physical market participants (e.g. those entities with "steel in the ground") relative to non-commercial (non-physical asset) market participants.

Additionally, mandatory clearing and the requirement of posting collateral may make it too expensive for some market participants, either with or without physical assets, to continue to participate in energy markets. This would raise the cost of capital (because of the limited ability to hedge risk) and reduce capital available for investment in the development and marketing of natural gas supplies. In times where capital is more difficult to raise, and even when it is not, increased (or worse, mandated) capital requirements to offset natural gas production risk may leave many of the United States' small producers and even some large producers with two bad choices: 1) do not hedge risk or 2) do not drill. The barrier to entry into the natural gas market over the long run will discourage exploration and production.

In summary, mandatory clearing would reduce the level of participation in the market for OTC natural gas derivatives because of the standardization, the change to requirements for market participants and the increased capitalization and collateral costs. Over time, these changes will result in a reduction of natural gas supplies and higher energy costs to consumers.

2. Position limit exemptions for bona fide hedging transactions should remain available for market participants hedging energy commodity risk and not be limited to only those market participants holding physical assets or hedging risk tied to transactions involving physical assets.

As discussed above, it is important for companies with physical assets to have the ability to hedge their physical assets with OTC natural gas contract positions. It is mechanisms like the bona fide hedge exemption that allow such companies to adequately hedge the risk associated with their physical assets. However, NGSA does not support changing the definition of a bona fide hedging to exclude those that do not have physical assets or those transactions not tied to physical assets. Although such a change to the definition of a bona fide hedging transaction does not directly affect NGSA members, it may affect others in the market, such as swap dealers. The affect on others may displace the other market participants or decrease the amount of transactions into which a participant may enter, decreasing energy market liquidity. It is this decrease in liquidity that would affect NGSA members. Reducing liquidity increases volatility.

Companies with large physical commodity positions (like natural gas producers and marketers) must have the ability to hedge their positions to manage commodity price risk if they choose to do so. Mechanisms like the Commodity Futures Trading Commission (CFTC) current limit exemptions for bona fide hedging transactions are an important characteristic of the energy market because the limit exemption allows some natural gas producers, marketers, manufacturers and processors of a commodity to offset or reduce the risk of changes in the value of assets owned, such as natural gas still in the ground. This ability to protect the asset from changes in its value is particularly important given the scale of the investment required to produce energy resources, the overall discovery risk and the amount of time it takes for the resource to generate revenue.

Further, eliminating the limit exemption for bona fide hedging would have the unintended consequence of exposing some energy company assets (which include supply in the ground) to valuation volatility that could have otherwise been mitigated. Overtime the inability to mitigate asset value volatility through the financial markets, particularly for natural gas yet to be produced, may translate to greater volatility in the supply response because some producers, acting independently in the interests of shareholders, may be forced to react to short-term changes in commodity prices, instead of a longer term "hedged" position. Instead of reducing volatility, for some energy companies the energy supply response may become captive to it.

In the alternative, NGSA suggests that to address concerns with the bona fide hedge exemption, Congress could establish regulatory agency accountability over the exchanges giving the exchange greater authority to grant or deny a hedge exemption request.

3. The ability to establish margin requirements must remain with the regulated exchanges, with regulatory oversight, to ensure that they are dynamic and reflective of individual commodity markets.

Margin requirements should not be static, but should remain fluid, changing with the energy or commodity markets and overarching economic conditions. Congressionally-set margin requirements, as well as margin requirements set through a regulatory process, would not be dynamic enough to respond to rapidly changing market and economic conditions.

Markets can function well with margin requirements; the key is setting them correctly. As such, the establishment and modification of margin requirements must remain voluntary and left to the exchanges and self-regulating organizations (SROs).

If Congress elects to act in this area, one option would be the regulatory oversight of margin requirement testing. Margin requirement testing, subject to regulatory oversight, could be used to periodically validate the adequacy of the exchange and SRO margin requirements in the event of extensive member defaults under current economic conditions. Such testing would provide oversight protection, mitigate systemic risk and avoid the costs associated with unnecessary or inadequate capital requirements.

4. Position and accountability limits should remain dynamic and the discretion to establish such limits should rest with the regulated exchange.

As part of the exchange's responsibility to establish and maintain an orderly market comes the responsibility of establishing position and accountability limits with regulatory oversight. NGSA does not oppose mandatory position and accountability limits on unregulated exchange platforms, if they are established voluntarily by the unregulated exchanges. Further, position and accountability limits alone do not remove volatility in the market; however, such limits should remain flexible in order to respond to changing market conditions.

NGSA and its members are committed to legislative and regulatory changes that will maintain a robust and transparent natural gas and energy market. Thus, NGSA urges Congress and the Administration to carefully balance the benefit of increased financial market regulation with its impact on energy markets.

We are concerned that Congressional efforts to address the financial market may have severe unintended consequences, as specifically outlined in this letter, for the natural gas industry and consequently energy consumers. For instance, if cash collateral had been required to manage the risk associated with the recent supply development projects that contributed significantly to the first natural gas supply increase in 35 years, the recent growth in U.S. natural gas supply may not have come to fruition. In fact, recent studies indicate a 100-year supply of natural gas in North America. This increase in accessible, technically recoverable natural gas supplies is the direct result of the industry's capital investment in exploration and production and new technology. Under many of the current OTC regulatory proposals, the capital that could be directed toward exploration and production or technological advances instead would be necessary for risk management. To help ensure the continued contribution of natural gas to the economy, consumers and the environment, Congress must avoid policies that increase capital costs and reduce liquidity in natural gas markets.

Thank you for your consideration and we look forward to participating in the dialogue regarding financial market reform.

Sincerely,

Skip Horvath

Copy:

The Honorable Tom Harkin,
Chairman, U.S. Senate Committee on
Agriculture, Nutrition & Forestry

The Honorable Saxby Chambliss
Ranking Member, U.S. Senate
Committee on Agriculture, Nutrition &
Forestry

The Honorable Chris Dodd
Chairman, U.S. Senate Committee on
Banking, Housing & Urban Affairs

The Honorable Richard Shelby
Ranking Member, U.S. Senate
Committee on
Banking, Housing & Urban Affairs

The Honorable Max Baucus
Chairman, U.S. Senate Committee on
Finance

The Honorable Chuck Grassley
Ranking Member, U.S. Senate
Committee on Finance

The Honorable Collin Peterson
Chairman, U.S. House Committee on
Agriculture

The Honorable Frank Lucas
Ranking Member, U.S. House
Committee on Agriculture

The Honorable Henry Waxman
Chairman, U.S. House Committee on
Energy and Commerce

The Honorable Joe Barton
Ranking Member, U.S. House
Committee on Energy and Commerce

The Honorable Barney Frank
Chairman, U.S. House Committee on
Financial Services

The Honorable Spencer Bachus
Ranking Member, U.S. House
Committee on Financial Services

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