NEWS

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Wrong OTC Derivatives Reform Action Could Drain $900 Billion from U.S. Economy, NGSA Says in Joint Letter

(Washington, D.C.) House floor action to reform over-the-counter (OTC) derivatives markets could raise commercial hedging and risk-management costs enormously unless language explicitly excluding those activities is included, according to a letter from the Natural Gas Supply Association (NGSA) and the American Exploration and Production Council (AXPC) to Speaker of the House Nancy Pelosi and leaders of the House Agriculture, Energy and Commerce and Financial Services Committees. **NGSA and AXPC said mandatory clearing of all OTC derivatives could remove as much as $900 billion from the fragile U.S. economy.**

"We have serious concerns about forcing the trading of over-the-counter energy derivatives onto an exchange," said R. Skip Horvath, president and CEO of NGSA. "Mandating centralized clearing and margins is a recipe for unintended negative economic consequences. If all estimated hedging transactions are forced into clearing, it could either cost the U.S. economy an estimated $900 billion -- the price tag of the entire 2009 economic stimulus package and then some – or force many companies to scale back their hedging, exposing customers to increased commodity and financial risk."

Horvath continued, "It would cost the energy industry alone tens of billions of dollars, effectively drive smaller participants out of the market and centralize risk – all at a time when dollars are instead needed to create energy jobs, build infrastructure and meet environmental goals. That's the exact opposite of the effect that policy makers intend and couldn't come at a worse time for the struggling economy. "

In the joint letter, the organizations said OTC energy derivatives used for hedging should be explicitly exempted from mandatory clearing requirements, stating that mandated clearing "could drain the U.S. economy of approximately $900 billion in productive capital … Mandatory clearing requirements would place an additional cash burden specifically on U.S. energy exploration and production that could be reasonably estimated at around $100 billion, meaning that less capital would be available for drilling."

Horvath said, "Mandatory clearing is too high a price for energy derivatives transactions that do not contribute to systemic risk."

The NGSA-AXPC letter said mandatory clearing of all OTC transactions would not only hurt consumers by diverting hundreds of billions of dollars from any U.S. economic recovery, it also would:

- Increase risk by shifting from numerous, diverse counterparties to a few central clearinghouses;
- Disregard credit quality, disadvantaging many energy participants who often possess significant physical assets and high credit quality, and further creating an environment that favors and attracts more leveraged market participants;
- Raise the cost of participating in the market, reducing the number of participants and resulting in increased commodity price volatility.

A copy of the letter to House leaders follows.

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December 7, 2009

The Honorable Nancy Pelosi
Speaker of the House of Representatives

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

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

Dear Madam Speaker, Committee Chairmen and Ranking Members:

The Natural Gas Supply Association (NGSA) and The American Exploration and Production Council (AXPC) understand the consumer and congressional interest in establishing a comprehensive regulatory framework for transactions in over-the-counter (OTC) derivative energy markets. However, without explicitly exempting derivatives used for hedging from clearing requirements as proposed, Title III of H.R. 4173 (The Wall Street Reform and Consumer Protection Act of 2009) would have many serious consequences for the U.S. economy and could negatively impact 65 million U.S. natural gas consumers.

Legislation intended to bolster consumer confidence in the U.S. financial system must do so without harming the economy or the industries that do not pose systemic risk. Derivatives used for hedging, or for reducing commercial risk, do not pose a systemic risk[1] and thus must be excluded from a clearing mandate. Absent a clear exclusion for derivatives used for hedging, reducing or managing operational and financial risk, the legislation risks costing the economy hundreds of billions of dollars. Without a clear exclusion, physical natural gas supply agreements may be caught in the definition of "swap" and included in a clearing mandate impacting operations.

Specifically, mandating clearing of over-the-counter derivatives (by forcing trading onto an exchange or mandating centralized clearing and margining for over-the counter

[1] Schwarcz, Steven L. (2008). Systemic Risk. *The Georgetown Law Journal* , 220.

derivatives) *could drain the U.S. economy of approximately $900 billion in productive capital* that companies would simply have to post or set aside to insure their risk-management transactions. The alternative would be for these companies to scale back their hedging activities, exposing their customers to greater commodity and financial risks. The estimated drain on the economy from this diversion of capital would increase the stress on an already fragile economy beyond the effect of mandatory clearing. Overly broad definitions of "swap dealer" and "major swap participant" risk applying systemic risk regulation to entities that do not pose a systemic risk.

Also, mandatory clearing requirements would place an additional cash burden specifically on U.S. exploration and production that could be reasonably estimated at around $100 billion, meaning that less capital would be available for drilling. *Without exempting derivatives used for hedging, this legislation would significantly impact natural gas jobs, government revenues and local economic value.* In 2008, the U.S. natural gas industry contributed more than $7 billion to the U.S. treasury and nearly $2 million to state and tribal governments in royalty and other non-tax payments. In addition to the government revenues, the natural gas industry employs 3 to 4 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, heats 60 million U.S. homes, fuels more than 100,000 vehicles in the U.S., and is the source of about 25 percent of U.S. electricity generation, as well as overall U.S. energy consumption.

If Congressional goals are to protect consumers from systemic risk and ensure the financial integrity of the U.S. financial system, any legislation that mandates clearing of hedging done for the purpose of mitigating commercial risk is contrary to that objective. Specifically, mandatory clearing –

1. Centralizes risk onto very few exchanges; risk that is currently diversified across a variety of counterparties throughout the over-the-counter market. In fact, *centralized clearing increases systemic risk.*[2]
2. Neutralizes differences in credit quality across market participants because all entities, regardless of debt levels, post the same amount of capital for a given transaction. While this may sound fair or reasonable, it actually disadvantages entities with higher credit quality (including entities with physical assets) relative to more leveraged market participants.
3. Elevates the cost of participating in the market, making it more difficult and expensive for businesses to manage commodity price volatility. Undoubtedly, higher participation costs will reduce market participants. Fewer market participants *increase* volatility.

At the end of the day, without the discipline to exclude transactions and entities that do not pose a systemic risk from clearing requirements, taxpayers will be greeted with derivatives reform legislation that actually *increases* systemic risk, *incentivizes* lower credit quality entities' participation in the market, and *limits* the risk management products availability or economic viability of risk management tools available to consumers. Any

[2] Shadab, Houman B. (2009). Guilty by Association? Regulating Credit Default Swaps . The Mercatus Center, George Mason University , 41.

benefits from such legislation will come at the expense of the U.S. economy and energy consumers.

We urge you to carefully consider the potential unintended consequences of any derivatives reform initiative. Thank you for your consideration and we look forward to participating in the ongoing dialogue regarding financial market reform.

Sincerely,

Skip Horvath, President
Natural Gas Supply Association

Bruce Thompson, President
The American Exploration & Production Council

Copy: Members of the U.S. House of Representatives