Natural Gas Supply Association

NEWS

For Immediate Release: April 15, 2010

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Natural Gas Companies and Corn Growers Warn of $900 Billion Cost of Mandatory Clearing to U.S. Economy

(Washington, D.C.) -- Legislation that would force many thousands of commodity derivative transactions that are normally handled through over-the-counter derivative markets to clear would carry a tremendous overall cost to the economy and would force the setting aside of billions of dollars of productive capital, according to the Natural Gas Supply Association and the National Corn Growers Association.

In a joint letter to Senators Harry Reid, Blanche Lincoln and Saxby Chambliss, the associations asked the senators to exempt commercial end-users from OTC derivatives market clearing mandates. The letter marks the National Corn Growers Association as a leader among agricultural trade associations in opposing mandatory clearing in the OTC markets.

"A provision to force clearing of derivative transactions by commercial end-users such as natural gas companies and corn growers is counterproductive to the health and stability of the market and to meaningful financial reform," said R. Skip Horvath, president and CEO of the Natural Gas Supply Association. "These are transactions that already have counterparties and are backed by assets in the ground. Setting aside hundreds of billions of dollars under a single clearinghouse not only diverts productive capital from a struggling economy, it centralizes risk that until now has been successfully shared by numerous counterparties."

Horvath said, "Looking beyond our industries to the entire derivatives market, we estimate this provision would drain a staggering $900 billion of productive capital from the U.S. economy – effectively cancelling out the entire economic stimulus package of 2009."

He said, "Today is the day that millions of Americans do their due diligence and file tax returns. We are doing our due diligence today in cautioning the Senate that mandatory clearing in the OTC derivatives market will hurt the natural gas and corn industries, energy and food consumers and ultimately penalize the entire economy. The use of OTC derivatives markets for natural gas and corn commodities has historically and successfully reduced risk and provided market liquidity – this legislation would reverse that."

The joint letter to Senators Reid, Lincoln and Chambliss follows.

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April 15, 2010

The Honorable Harry Reid, Senate Majority Leader
522 Hart Senate Office Bldg.
Washington, DC 20510

The Honorable Blanche Lincoln, Chairman, Senate Committee on Agriculture, Nutrition and Forestry
355 Dirksen Senate Office Bldg.
Washington, DC 20510

The Honorable Saxby Chambliss, Ranking Member, Senate Committee on Agriculture, Nutrition and Forestry
416 Russell Senate Office Bldg.
Washington, DC 20510

Dear Senate Majority Leader Reid, Chairman Lincoln and Senator Chambliss:

The Natural Gas Supply Association (NGSA) and the National Corn Growers Association (NCGA) understand the consumer and congressional interest in establishing a comprehensive regulatory framework for financial markets and specifically the over-the-counter (OTC) derivatives market. However, financial reform must not come at the expense of America's energy and commodity producers, consumers, and ultimately, the entire U.S. economy.

In order to protect our commodity markets and customers from heightened exposure to risk and to protect the U.S. economy from a staggering potential $900 billion economic drain, language concerning the OTC derivatives market must include a clear exclusion from clearing requirements for commercial end-users. Without such an exclusion, energy and commodity producers will be forced to divert capital that would have otherwise been invested in producing energy, food and thousands of jobs, while risk would be increased rather than decreased. These adverse consequences are particularly unfortunate because our businesses do not pose a systemic financial risk to the economy.

Financial reform legislation that does not explicitly exempt commercial end-users and derivatives used for hedging from clearing requirements will have many serious consequences for the U.S. economy and could negatively impact 65 million U.S. natural gas consumers and countless U.S. corn consumers. The commercial end-user exception from clearing is essential to ensuring that commercial market participants (like the corn growers and energy companies that produce energy and agricultural products) have the ability to put capital to work in their businesses producing products such as energy and corn, instead of directing that capital to Wall Street.

The Senate Committee on Agriculture, Nutrition and Forestry contemplated bipartisan language regarding a commodity end-user clearing exclusion that if offered and incorporated into the financial reform package could have addressed the commercial end-user concerns regarding mandatory clearing requirements. Without an end-user clearing exclusion, legislation intended to bolster consumer confidence in the U.S. financial system risks harming the economy and the industries that do not pose systemic risk. Derivatives used for hedging, or for reducing commercial risk, as they are used by our companies, 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. The Senate Committee on Agriculture, Nutrition and Forestry must restore its commitment to a bipartisan derivatives title that recognizes the importance of investment U.S. commodity businesses.

Mandating clearing of over-the-counter derivatives (by forcing trading onto an exchange or mandating centralized clearing and margining for over-the counter derivatives) *could drain the U.S. economy of approximately $900 billion[2] 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.

Mandatory clearing requirements would place an additional cash burden specifically on the U.S. energy and agricultural production industries meaning that these industries would have less capital available for drilling and product production. *Without exempting commodity end-users and derivatives used for hedging, this legislation would significantly impact the U.S. agricultural industry, natural gas jobs, government revenues and local economic value.*

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

[2] Estimate based on the U.S. portion of global credit exposure that is not already collateralized. Data sources include the Bank for International Settlements, Monetary and Economic Department OTC Derivatives Market Activity Report (May 2009), "Cross-border derivatives exposures: how global are derivatives markets?" by Sally Davies of the Division of International Finance, Board of Governors of the Federal Reserve System, and Country Exposure Report collected on the FFIEC 009 report that shows U.S. banks' exposure from derivatives. For the detailed calculation methodology, please contact the Natural Gas Supply Association at 202-326-9314.

Founded in 1957, NCGA is the largest trade organization in the United States representing corn growers representing 35,000 dues-paying corn farmers nationwide and the interests of more than 300,000 growers who contribute through corn checkoff programs in their states. NCGA and its 48 affiliated state associations and checkoff organizations work together to create and increase opportunities for their members and their industry.

In 2008, the U.S. natural gas industry contributed more than $7 billion to the U.S. treasury and millions more 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.*[3]
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 benefits from such legislation will come at the expense of the U.S. economy and energy consumers.

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

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,

National Corn Growers Association
Natural Gas Supply Association

Copy:

The Honorable Christopher Dodd, Chairman, Senate Banking, Housing and Urban Affairs

The Honorable Richard Shelby, Ranking Member, Senate Banking, Housing and Urban Affairs

Members of the U.S. Senate