10-012
COMMENT
CL-00069

From: Soto, Andrew <ASoto@aga.org>
Sent: Monday, September 20, 2010 3:53 PM
To: secretary <secretary@CFTC.gov>
Cc: dfadefinitions <dfadefinitions@CFTC.gov>
Subject: AGA Comments on Key Definitions ANOPR - RIN 3235-AK65; RIN3038-AD06
Attach: 100920 AGA Comments on Key Definitions ANOPR.pdf

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

Dear Mr. Stawick:
Attached for filing please find a copy of the Comments of the American Gas Association on the Commission's Advance Notice of Proposed Rulemaking on
Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act. 75 Fed. Reg. 51,429 (Aug. 20, 2010).

If you have any questions regarding this filing, please feel free to contact me. Thank you for your consideration.

Sincerely,

Andrew K. Soto | Senior Managing Counsel, Regulatory Affairs
American Gas Association
400 N. Capitol St., NW | Washington DC 20001
202.824.7215 | asoto@aga.org | fax 202.824.9086
cell 703.975.4022 | www.aga.org

- Clean Fuel Green Fuel –

UNITED STATES OF AMERICA
BEFORE THE
COMMODITY FUTURES TRADING COMMISSION

Definitions Contained in Title VII of Dodd-Frank	)	RIN 3235-AK65
Wall Street Reform and Consumer Protection Act	)	RIN 3038-AD06

COMMENTS OF THE AMERICAN GAS ASSOCIATION

Pursuant to the Advance Notice of Proposed Rulemaking and Request for Comments ("ANOPR") issued August 16, 2010,[1] by the Commodity Futures Trading Commission ("CFTC" or "Commission") in the above-referenced proceedings and section 13.4 of the Commission's regulations,[2] the American Gas Association ("AGA") respectfully submits these comments. AGA supports the Commission's efforts to ensure that the financial markets related to energy commodities function in a transparent and efficient manner, and urges the Commission to ensure that natural gas local distribution companies ("LDCs") are not considered "Swap Dealers" or "Major Swap Participants" as the Commission defines those terms. LDCs engage in commercial hedging activities primarily to limit volatility in the cost of natural gas purchased to provide service to their retail customers and do not pose a systemic risk to the U.S. financial system. In addition, AGA urges the Commission to refine the definition of "Swap" to clearly exclude physical transactions.

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[1] *Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act*, 75 Fed. Reg. 51,429 (August 20, 2010).
[2] 17 C.F.R. § 13.4 (2009).

I. COMMUNICATIONS

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

Andrew K. Soto
American Gas Association
400 North Capitol Street, NW
Washington, DC 20001
(202) 824-7215
asoto@aga.org

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.[3]

AGA members engage in financial risk management transactions in markets regulated by the Commission, including the trading of swaps as they may be defined in this proceeding. AGA members will be directly affected by the proposed regulations. Accordingly, AGA has a substantial interest in the outcome of this proceeding.

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[3] For more information, please visit www.aga.org.

III. COMMENTS

A. Introduction

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act")[4] requires the CFTC and the Securities and Exchange Commission ("SEC"), in consultation with the Board of Governors of the Federal Reserve System, to further define several key definitions used in the Act, including "Swap", "Swap Dealer", and "Major Swap Participant."[5] The ANOPR seeks comments on all aspects of the key definitions and urges commenters to address whether the definitions should be based on qualitative and quantitative factors and what those factors should be. Factors may be drawn from analogous areas of law, economics, industry practice, or from experiences relevant to the commenter.[6]

B. LDCs Should Not Be Considered "Swap Dealers" Or "Major Swap Participants."

LDCs are end users as contemplated by the legislative history of the Dodd-Frank Act. The June 30, 2010 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 ("Dodd-Lincoln letter") emphasized that the Dodd-Frank Act did not intend to regulate end users as Swap Dealers or Major Swap Participants. It further stated that the Act does not authorize the CFTC to impose capital and margin requirements on end users, and that the capital and margin requirements were intended to mitigate risk to the financial system, not impose requirements on entities that are appropriately managing their commercial risk. The letter explained that the Act specifically

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[4] Pub. L. No. 111-203 (July 21, 2010).
[5] ANOPR, 75 Fed. Reg. at 51,429.
[6] *Id.* at 51,430.

authorizes end users to enter into uncleared swaps and use non-cash collateral to ensure that end users have the flexibility they need to effectively hedge their risks at reasonable cost.

Congress' clear intent was that LDCs would qualify as commercial end users, and would not be classified as Swap Dealers or Major Swap Participants. The Dodd-Lincoln letter recognized that entities that use swaps principally to hedge commercial risk are end users. LDCs fit this description, because they predominately use swaps to reduce volatility in the cost to provide natural gas service, especially the cost of the physical gas commodities that they purchase for resale to retail consumers. In fact, their activities in swaps markets are functionally equivalent to "energy companies who produce and distribute power," which the Dodd-Lincoln letter specifically identified as commercial end users.

As the Dodd-Lincoln letter noted, LDCs did not contribute to the financial crisis and do not pose a systemic threat to the U.S. financial system. As state-regulated entities, LDCs have little incentive to engage in speculative trading and largely limit their trading activity to hedging. Hedging poses a lower risk to the financial system because any losses on swaps are offset by gains in physical commodity transactions. LDCs also do not have high levels of financial leverage and do not maintain large enough positions in swaps markets to endanger the health of the financial system as a whole, as compared to the positions held by, for example, American International Group, Bear Stearns, Lehman Brothers or other financial institutions that foundered during the 2008 financial crisis.

The Dodd-Frank Act imposes a variety of requirements on entities defined as Swap Dealers or Major Swap Participants. For example, Swap Dealers and Major Swap Participants must comply with registration requirements, business conduct standards, capital and margin rules, and reporting requirements. In addition, the Act specifically states that any entity that falls

within the definition of a Swap Dealer or a Major Swap Participant cannot be considered a commercial end user free to enter into customized swaps. AGA believes that imposing such requirements on LDCs would expose them to significant additional administrative and financial costs, and would likely raise costs to customers and/or expose customers to increased price risk. Accordingly, AGA urges the Commission to ensure that LDCs are not considered Swap Dealers or Major Swap Participants as defined in this proceeding.

LDCs participate in physical and financial natural gas markets on behalf of themselves and their retail customers. The costs and price risks associated with the physical and financial transactions to meet the gas supply needs are borne by retail customers. LDCs pass through the commodity-related costs of providing service directly to their retail customers through purchased gas adjustment clauses approved by state regulators, in some cases with a modest portion of the price risk borne by or retained by the LDC as an incentive to purchase and hedge efficiently. LDCs have a strong interest in managing their gas supply portfolios to ensure that the overall price for natural gas service remains stable and affordable. They use a variety of financial tools to manage price risks on behalf of their retail customers.

Classifying LDCs as Swap Dealers or Major Swap Participants would increase costs for customers. The cost of any capital or margin requirements applied to an LDC as a result of its being considered a Swap Dealer or Major Swap Participant would be borne by the LDC's retail customers either through higher prices for natural gas or increased exposure to risk. Moreover, complying with the registration, business conduct, and reporting requirements applicable to Swap Dealers and Major Swap Participants would impose significant administrative costs because LDCs are not currently subject to Commission oversight and would need to develop entirely new management systems to ensure compliance with Commission regulations for Swap

Dealers and Major Swap Participants. Some CFTC requirements for Swap Dealers and Major Swap Participants may also duplicate requirements imposed by state regulators, potentially imposing those costs unnecessarily. Further, because LDCs, as end users, are hedging their commercial risk with underlying physical commodities, they do not pose a systemic risk to the financial system. As a result, imposing these costs would provide little benefit to financial markets.

Restricting LDCs from entering into uncleared swaps would potentially increase their risk, because it would limit their ability to use customized swap transactions to mitigate non-standard business risks. For example, many LDCs serve customers located far from major commodity trading hubs and some LDCs 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, including customers in remote locations. Customized transactions often enable LDCs to mitigate those unusual risks more precisely than standardized products by fixing a price for natural gas at a point other than a major trading hub or hedging against the possibility that customers will migrate to unregulated retail marketers.

1. The Swap Dealer Definition Should Exclude LDCs.

The Dodd-Frank Act defines Swap Dealers as any entity who "regularly enters into swaps with counterparties as an ordinary course of business for its own account," and requires the Commission to exempt from this designation any entity that engages in only a "de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers."[7] AGA believes that LDCs should fall outside the Swap Dealer definition for several reasons, and urges the Commission to make the clarifications suggested herein.

[7] *See* ANOPR, 75 Fed. Reg. at 51,431.

AGA does not believe that LDC swap market activities constitute swap dealing – *i.e.*, "market making" or a purchase or sale of a swap with the intent of reselling the associated cash flow or liability to another entity. LDCs predominately and often exclusively use swaps to hedge their physical purchases of natural gas and do not "deal" in swaps. While an LDC may at times be "over-hedged," *i.e.*, their hedge positions may exceed the notional amount required to hedge the underlying physical gas supplies required to meet the needs of their retail customers, these positions are often the result of forecasting error – the forecasted gas supply needs were greater than actual usage. The Commission should clarify that hedges against physical commodity purchases do not constitute "swaps with counterparties … for [an LDC's] own account" and cannot, by themselves, result in an entity being classified a Swap Dealer. In addition, the Commission should clarify that over-hedged positions as a result of forecasting error do not constitute swap dealing and/or that such positions are considered de minimis. Hedging transactions to mitigate commercial risk should not cause an LDC to be classified as a Swap Dealer.

2. The Major Swap Participant Definition Should Exclude LDCs.

The Dodd-Frank Act defines Major Swap Participants as entities, other than Swap Dealers, that (1) maintain "substantial positions" in swaps, excluding "positions held for hedging or mitigating commercial risk", (2) "whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets," or (3) are financial entities that are "highly leveraged related to the amount of capital" they hold and maintain a "substantial position in outstanding swaps." The Act further directs CFTC to define "substantial position" at "the threshold that the Commission determines to be prudent for the … oversight of entities that are systemically

important or can significantly impact the financial system of the United States." AGA believes that Congress's intent was that LDCs would fall outside this definition, and asks that the Commission make several clarifications to the definition of Major Swap Participant in its regulations.

LDCs enter into swaps principally to hedge against the price volatility associated with providing natural gas service. Swaps are used principally to reduce volatility in the cost of gas commodity purchases on behalf of retail customers, but can also be used to hedge against volatility in other factors affecting LDC business costs, such as interest rates, materials or weather. Some LDCs also operate energy production or storage facilities and may use swaps as a means of reducing the commercial risk of those facilities, particularly the exposure to energy price volatility. The Commission should make clear that these activities, because of their demonstrable connection to physical energy markets and services, qualify as "hedging or mitigating commercial risk."[8]

The Commission should recognize that LDCs do not pose a systemic risk to the U.S. financial system because while they hold positions in swaps they do so almost exclusively for hedging or mitigating commercial risk. LDCs engage in swaps trading to reduce commercial risk, which has an inherently lower risk than speculative activity, because any losses will be offset by gains in physical markets. As noted above, LDCs also are not sufficiently large or

[8] The Commission should also give serious consideration to including a definition of "commercial risk" in its regulations along the lines proposed by the Edison Electric Institute ("EEI"). Including such a definition would provide LDCs with greater certainty that engaging in particular types of transactions will not cause them to be misclassified as Major Swap Participants. AGA believes that the definition proposed by EEI would encompass the hedging transactions entered into by LDCs, and urges its adoption by the Commission with one minor clarification. Unlike electricity, natural gas is often stored and LDCs frequently own and/or contract for natural gas storage capacity to support their commodity purchases. AGA presumes that EEI's proposed definition implicitly includes storage, since storage is part of the process of "merchandising, marketing or distribution of a commodity" in the natural gas industry.

interconnected to other players in the financial system through a high volume of swaps trades to pose a systemic risk. Since the primary purpose of Title VII of the Act was to reduce systemic risk, the positions held by LDCs for the purpose of mitigating commercial risk should not be considered "substantial" if they do not pose such a risk. The Commission should, therefore, make clear that entities may not have "substantial positions" unless they have swaps holdings, net of commercial risk hedges, with a value at risk significant enough to pose a systemic risk to U.S. financial system. In addition, it should ensure that Major Swap Participants include only those that are highly interconnected with important players in the financial system by limiting the definition of "substantial positions" to those entities that engage in high volume trading activity with a large number of counterparties. To set numerical thresholds for each of these measures, AGA urges the Commission to rely upon information about those entities that triggered the 2008 financial crisis – American International Group, Lehman Brothers, Bear Stearns and others.

Importantly, LDCs are subject to regulation by state public utility commissions. That regulation severely restricts their ability to maintain highly leveraged capital structures. Typically, entities owning LDCs maintain a capital structure that is approximately 50% equity and 50% debt, a level far more conservative than most organizations that focus on swaps trading. By contrast, organizations that focus to a greater extent on trading maintain lower equity ratios. In addition, since LDCs typically own large quantities of tangible assets (*i.e.*, gas distribution systems and other energy facilities) that are recorded on their books at historical cost and rely on long-term debt for financing, sudden changes in their financial leverage are not likely to occur. Entities that focus their business on swaps trading are much more likely to experience severe changes in their financial leverage, because their assets are periodically revalued based on market prices and because they may rely to a greater extent on short-term debt instruments that

may be terminated or may have to be renewed suddenly at higher cost. The Commission should ensure that its definition of Major Swap Participant excludes entities with conservative capital structures and business lines, like LDCs.

C. The Swaps Definition Should Exclude Transactions Traditionally Considered Physical Deals

The Dodd-Frank Act classifies a variety of contracts and agreements as "Swaps" subject to the Commission's oversight, but specifically excludes "any contract for sale of a commodity for future delivery" and "any non-financial commodity or security for deferred shipment, so long as the transaction is intended to be physically-settled." AGA believes that the Commission's effort to refine the Swap definition is critically important, and that the Commission should endeavor to clearly exclude from the definition transactions that have traditionally been considered physical transactions, based on, among other things, the criteria described below. If the definition of Swaps includes transactions that have traditionally been viewed as physical transactions, they could be simultaneously subject to the oversight of other Federal agencies, such as the Federal Energy Regulatory Commission. Such a result would confuse market participants about their compliance obligations and would be disruptive to the physical commodity markets that LDCs and their affiliates rely upon to maintain natural gas service critical to the health and safety of the public.

When judging the intent of parties to physically or financially settle a transaction, the Commission should focus on the parties' intent when the transaction is made. An after-the-fact examination of the percentage of contracts of the same type that financially settle would not reliably gauge parties' intentions, because market and supplier circumstances may change significantly between the execution of the contract and the delivery date. Additionally, simply

because some users of a contract choose to financially settle does not mean that other users, who may have different business needs, will do the same.

AGA believes that most natural gas transactions contain terms that clearly identify them as contracts in which physical delivery is intended. These contracts should not be classified as Swaps. Many LDCs and their affiliates purchase natural gas under the North American Energy Standards Board's Base Contract ("NAESB Base Contract"), a master agreement that allows the parties to enter into physical transactions of varying lengths using a simple one-page transaction confirmation. Neither the NAESB Base Contract nor the transaction confirmation provides procedures for financial settlement instead of physical delivery of the agreed upon quantities. Thus, the parties must assume and intend that all transactions are likely to go to physical delivery. By contrast, the International Swap Dealers Association Master Agreement ("ISDA Agreement"), which many LDCs and their affiliates use for swaps transactions, contemplates that transactions may be financially settled or go to physical delivery. The terms of each transaction are specified in each transaction confirmation. AGA requests that the Commission recognize that contracts that do not contemplate financial settlement prior to physical delivery are not Swaps.

Whether a contract is intended to result in physical delivery can also be deduced from other contract terms. For example, LDCs frequently enter into contracts where the strike price is a published price index, rather than a fixed number. Such contracts include "take-or-release" contracts, under which the LDC pays a counterparty for the right to purchase a specified amount of natural gas each month during the term of the contract at physical spot market prices published in an energy industry periodical or at the closing price on a futures exchange. Prior to each month of the contract term, the LDC must decide whether to "take" gas for the upcoming

month or "release" the supplier from its obligation for the month. The contract is clearly intended to go to physical delivery, since the price for the gas to be provided is not known until after the decision is made to take the gas or release the counterparty. To prevent such contracts from inadvertently being classified as Swaps, AGA urges the Commission to specify in its rules that all contracts that require a decision about whether the contracting party will take physical delivery of natural gas before the price for that gas is known, including take-or-pay contracts, are not Swaps.

The terms of many fixed-price contracts for natural gas can also indicate that physical delivery is intended. Physical purchases made in the daily market (*i.e.*, less than 24 hours ahead of delivery) or intra-day market (during the gas day in progress) will almost certainly go to physical delivery, since daily and intra-day gas markets have limited liquidity. The buyer cannot count on being able to financially settle its contract and must assume, when it enters into the contract, that it will have to take physical delivery of the gas. The regulations to be promulgated by the Commission should recognize that such short-term transactions are intended as physical deliveries.

Finally, Asset Management Arrangements ("AMAs") have become popular among LDCs in recent years, and should not be considered Swap transactions. Under an AMA, the LDC turns over all or a portion of its physical gas supply portfolio (*i.e.*, commodity purchase rights, interstate pipeline 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 LDC's distribution system as needed. The asset manager expects to earn a profit by marketing any commodity, transportation or storage rights not needed by the LDC 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.[9] Under FERC's revised regulations, a qualifying AMA has a specified delivery obligation to ensure that the interstate transportation and storage capacity is used to meet the physical gas supply needs of the AMA customer. Thus, the central purpose and intent of an AMA is to facilitate the physical delivery of natural gas. Accordingly, AGA urges the Commission to ensure that the definition of Swaps does not include Asset Management Arrangements used in the natural gas industry.

D. LDCs Should Be Treated Separately From Their Affiliates, If Necessary.

Many LDCs are affiliates of or owned by entities that control other energy-related firms. AGA believes that the affiliates of LDCs, whether subject to state rate regulation or not, should also be excluded from the definition of Swap Dealer and Major Swap Participant. LDC affiliates generally have lines of business similar to those of LDCs themselves. Many affiliates own or manage energy facilities, such as natural gas pipelines, oil and gas production, storage facilities, or electric generation. Some sell natural gas or other energy commodities to retail or wholesale customers that they produce or purchase from physical markets. Still others provide consumer energy services, like energy conservation upgrades or appliance maintenance. All or virtually all use swaps for the same general purposes as LDCs – for hedging against volatility in the cost of energy commodities and other costs integral to the cost of physical energy delivery. They do not "deal" in Swaps, nor do their business activities, finances or holdings make them a systemic risk to the U.S. financial system. Many are also subject to rate regulation by state or federal

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[9] *See Promotion of a More Efficient Capacity Release Market*, Order No. 712, 73 Fed. Reg. 37,058 (June 30, 2008), FERC Stats. & Regs., Regs. Preambles ¶ 31,271 (2008), *order on reh'g*, Order No. 712-A, 73 Fed. Reg. 72,692 (Dec. 1, 2008), FERC Stats. & Regs., Regs. Preambles ¶ 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).

regulators, and must structure their finances and business activities in a manner acceptable to those regulators. Even those that are not subject to rate regulation can be subject to greater oversight from regulators than many other businesses, *e.g.*, their mergers and acquisitions may be subject to state approval. Like LDCs, LDC affiliates should generally be considered end users, not Swap Dealers or Major Swap Participants.

It is possible that some LDCs may have affiliates now or in the future that engage in significant levels of speculative trading that the Commission wishes to oversee more closely. AGA believes that the criteria it suggests in this document will enable the Commission to identify holding companies that have such operations. In the event that the Commission classifies a holding company as a Swap Dealer or Major Swap Participant, AGA urges the Commission to exclude its LDC operations from that classification. As AGA indicated in its April 26, 2010 response to the Commission's position limits NOPR, state regulators require LDCs to maintain financial accounts and trading operations separate from their affiliates, and strictly limit the exchange of physical and swap market information between LDCs and their affiliates. Thus, an LDC should not be considered a Swap Dealer or Major Swap Participant even if affiliated business units should fall within those classifications.

IV. CONCLUSION

Wherefore, for the reasons stated above, the American Gas Association respectfully requests that the Commission consider these comments in this proceeding.

Respectfully submitted,

/s/ Andrew K. Soto

Andrew K. Soto
American Gas Association
400 N. Capitol Street, NW
Washington, DC 20001
(202) 824-7215
asoto@aga.org

September 20, 2010