

**UNITED STATES OF AMERICA  
COMMODITY FUTURES TRADING COMMISSION**

**The End-User Exemption to Mandatory Clearing of Swaps  
And  
Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap  
Participant,” “Major Security-Based Swap Participant” and “Eligible Contract  
Participant”**

**COMMENTS OF THE  
NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS**

The National Association of Regulatory Utility Commissioners (NARUC) appreciates the opportunity to provide comments to Commodity Futures Trading Commission (CFTC) in response to two proposed rules that interact with one another, *End-User Exemption to Mandatory Clearing of Swaps* 75 Fed. Reg. 80747 (Dec. 23, 2010) and *Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security Based Swap Participant,” and “Eligible Contract Participant”* 75 Fed. Reg. 80174 (Dec. 21, 2010). We are filing these comments in both rulemaking proceedings as the two rulemakings are interrelated.

**INTRODUCTION**

NARUC is the national organization of the State commissions responsible for economic and safety regulation of the retail operations of utilities. Specifically, NARUC’s members are obligated under State law to ensure the establishment and maintenance of such energy utility services as may be required by the public convenience and necessity, as well as ensuring that such services are provided at just and reasonable rates. NARUC’s members include the government agencies in the fifty States, the

District of Columbia, Puerto Rico, and the Virgin Islands charged with regulating the rates and terms and conditions of service associated with the intrastate operations of electric, natural gas, water, and telephone utilities. Both Congress<sup>1</sup> and the federal courts<sup>2</sup> have long recognized NARUC as the proper party to represent the collective interests of State regulatory commissions. NARUC sets policy as an organization through resolutions, sponsored by our committees and passed by the membership and the Executive Committee. Recently, we passed two resolutions addressing the issues of hedging and speculation. (*See* Appendix A for NARUC resolutions).

### **COMMENTS**

NARUC members regulate investor owned utilities and are responsible to ensure that utility rates are just and reasonable for consumers. Concern over price impacts and stability led our membership to examine hedging and speculation and to issue resolutions that recognize the value of legitimate hedging while condemning excessive speculation that causes volatility and inflated prices.

When Congress was debating the Dodd- Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), we supported the inclusion of an “end-user exemption” that would enable utilities to continue to pursue legitimate hedges over the counter without

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<sup>1</sup> See 47 U.S.C. § 410(c) (1971) (Congress designated NARUC to nominate members of Federal-State Joint Boards to consider issues of concern to both the Federal Communications Commission and State regulators with respect to universal service, separations, and related concerns); *Cf.* 47 U.S.C. § 254 (1996) (describing functions of the Joint Federal-State Board on Universal Service). *Cf. NARUC, et al. v. ICC*, 41 F.3d 721 (D.C. Cir 1994) (where the Court explains “...Carriers, to get the cards, applied to... [NARUC], an interstate umbrella organization that, as envisioned by Congress, played a role in drafting the regulations that the ICC issued to create the ‘bingo card’ system”).

<sup>2</sup> See *United States v. Southern Motor Carrier Rate Conference, Inc.*, 467 F. Supp. 471 (N.D. Ga. 1979), *aff’d* 672 F.2d 469 (5th Cir. 1982), *aff’d en banc on reh’g*, 702 F.2d 532 (5th Cir. 1983), *rev’d on other grounds*, 471 U.S. 48 (1985).

being required to go through clearinghouses and post margin. The clearing and margin requirements may have unintended consequences such as: (1) increasing costs in a manner that discourages hedging and leads to increased volatility for consumers, or (2) increasing costs for consumers as the margin requirements are passed along to consumers, and (3) diverting capital from necessary infrastructure investments.

We further urged Congress to avoid adding duplicative regulation in the energy markets currently regulated by the Federal Energy Regulatory Commission (FERC) or the Public Utility Commission of Texas in the case of the Electric Reliability Council of Texas (ERCOT).

*Instruction to Avoid Conflicting and Overlapping Jurisdiction*

One of NARUC's concerns is that overlapping regulation between CFTC and FERC and State commissions would result in confusion, instability and increased regulatory compliance costs. When promulgating this and other rules, the CFTC should take into consideration the instruction in Dodd- Frank to avoid unnecessary overlapping jurisdiction with other regulatory entities.

Additionally, Dodd-Frank specifically instructs the CFTC to enter into a memorandum of understanding with FERC that establishes procedures to ensure effective and efficient regulation, resolve conflicts about overlapping jurisdiction, and avoid conflicting or duplicative regulation.<sup>3</sup> The electricity market is a unique and highly

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<sup>3</sup> Public Law 111-203 (July 21, 2010), Sec 729 (a)(1) "The Commodity Futures Trading Commission and the Federal Energy Regulatory Commission shall, not later than 180 days after the date of the enactment of this Act, negotiate a memorandum of understanding to establish procedures for—  
(A) applying their respective authorities in a manner so as to ensure effective and efficient regulation in the public interest;  
(B) resolving conflicts concerning overlapping jurisdiction between the 2 agencies; and  
(C) avoiding, to the extent possible, conflicting or duplicative regulation."

regulated industry on the wholesale side by FERC and on the retail and distribution side by State utility commissions. The Dodd-Frank bill directs CFTC and FERC to clarify jurisdictional boundaries. The MOU should clarify that CFTC will not regulate agreements, contracts, transactions, products, market mechanisms, or services regulated pursuant to a tariff or rate schedule filed with FERC. This jurisdictional division should also apply to those transactions that would be regulated by FERC but that occur in ERCOT and therefore are within the jurisdiction of the Public Utilities Commission of Texas (PUCT). FERC (and the PUCT) have the expertise required to ensure that the transactions within their jurisdiction, which may be construed to fall within the CFTC's purview, such as financial transmission rights, are properly regulated to ensure just and reasonable rates for consumers.<sup>4</sup>

The utility sector, both electric and gas, are regulated by FERC and the State utility commissions that we represent. When promulgating its rules, CFTC should account for the fact that regulated utilities have accountability to existing regulatory bodies.

We urge CFTC to use these rulemakings and the MOU with FERC to follow the directive from Dodd-Frank and the spirit of President Obama's Executive Order on *Improving Regulation and Regulatory Review*<sup>5</sup> to create clear and sensible jurisdictional division that promotes "economic growth, innovation, competitiveness, and job

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<sup>4</sup> See Comments of the Federal Energy Regulatory Commission for a full explanation of FTRs.

<sup>5</sup> Executive Order 13563 (January 18, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-01-21/pdf/2011-1385.pdf>

creation”<sup>6</sup> rather than adding overlapping or duplicative regulation that causes confusion and uncertainty.

### *End-User Exemption*

The *End-User Exemption to Mandatory Clearing of Swaps* proposed rule provides a good framework for allowing utilities an elective exemption from the mandatory clearing and margin requirements if: (1) one party to a swap is not a financial entity, (2) is using the swap to hedge or mitigate commercial risk, and (3) notifies the Commission how it generally meets its financial obligations associated with entering into non-cleared swaps. 75 Fed. Reg. 80747 (Dec. 23, 2010). The proposed rule provides an opportunity for natural gas and electricity utilities to opt out of the mandatory clearing requirements.

We support the end-user exemption and agree with Chairman Gary Gensler’s testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, that “[t]ransactions involving non-financial entities do not present the same risk to the financial system as those solely between financial entities. Consistent with this, proposed rules on margin requirements should focus only on transactions between financial entities rather than those transactions that involve non-financial end-users.”<sup>7</sup> Utility end-users should be exempt from clearing and margin requirements if they choose to utilize the exemption.

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<sup>6</sup> *Id.*

<sup>7</sup> *Oversight of Dodd-Frank Implementation: A Progress Report by the Regulators at the Half-Year Mark Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 112<sup>th</sup> Cong. (Feb. 17, 2011) (Testimony of Gary Gensler, Commodity Futures Trading Commission) available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/ChairmanGaryGensler/index.htm>.

We support the end-user exemption rule as it is consistent with the plain language of Dodd-Frank. The end-user exemption, however, remains open to uncertainty given the evolving nature of the rulemakings (for example, CFTC has not yet issued a proposed rule to further define “swap”), the possibility that a utility may be determined to be a financial entity under the “swap dealer definition,” and the case-by-case evaluation of hedging activities that the CFTC proposes. “[T]he Commission preliminarily believes that whether a position is used to hedge or mitigate commercial risk should be determined by the facts and circumstances at the time the swap is entered into and should take into account the person’s overall hedging and risk management strategies.” 75 Fed. Reg. 80753. We encourage the CFTC to ensure that the rules allow bona fide utility natural gas and electricity hedges to be exempt from potentially expensive clearing and margin requirements while narrowly tailoring the exemption to prevent excessive speculation in these markets.

#### *Swap Dealer Definition*

The proposed rule *Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security Based Swap Participant,” and “Eligible Contract Participant”* 75 Fed. Reg. 80174 (Dec. 21, 2010) seeks to clarify these statutory definitions. Among these definitions, the swap dealer definition seems most likely to affect utilities that our members regulate. The swap dealer proposed rule expands on the test from Dodd-Frank for determining that an entity is a swap dealer if it: (1) holds itself out as a swap dealer, (2) makes a market in swaps, (3) regularly enters into swaps as an ordinary course of its business, (4) or is known as a dealer or trader in

swaps.<sup>8</sup> CFTC staff, in a meeting with NARUC staff on January 12, 2010, stated that it was likely that some large utilities may be considered swap dealers.<sup>9</sup> This assertion was based mainly on the proposition that since there is a market, it is likely that there is a swap dealer making that market. The swap dealer proposed rule says that “in sum, to determine if a party is a swap dealer, we would consider that person’s activities in relation to the other parties with which it interacts in the swap markets. If the person is available to accommodate demand for swaps from other parties, tends to propose terms, or tends to engage in other activities discussed above, then the person is likely to be a swap dealer.” 75 Fed. Reg. 80177.

The swap dealer definition leaves uncertainty as to whether or not utilities may be determined to be swap dealers. We are concerned that if regulated utilities are swept into the swap dealer definition in the course of pursuing legitimate hedges for their business, and are therefore subject to capital requirements and compliance costs, this will result in unnecessary increases in consumer costs and reduce the capital available for essential investments. Chairman Gensler, when discussing the major swap participants said that, “The major swap participant definition ... is very clearly limited to encompass only those

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<sup>8</sup> “(49) SWAP DEALER.—  
“(A) IN GENERAL.—The term ‘swap dealer’ means 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,  
Public Law 111-203 (July 21, 2010), Sec 721(49)

<sup>9</sup> *Ex Parte* Communication, NARUC to CFTC Staff, available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27496&SearchText=NARUC>.

entities that have risk large enough to pose a threat to the U.S. financial system.”<sup>10</sup> A similar test may be helpful when looking at swap dealers to ensure that the rule does not impose unnecessary burdens on entities that do not pose a significant risk to the economy as a whole.

### **CONCLUSION**

NARUC supports rules that will benefit consumers. We encourage CFTC to promulgate rules that allow utilities to enter into bona fide hedges to mitigate commercial risks and encourage market stability while limiting speculation in the market that can lead to price volatility and inflation. FERC and State commissions oversee the regulated utility sector; this existing regulation should inform the CFTC’s regulation of the sector in terms the end-user exemption and the swap dealer definition rulemakings and the statutorily required MOU with FERC.

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<sup>10</sup> *Assessing the Regulatory, Economic and Market Implications of the Dodd-Frank Derivatives Title Before the House Committee on Financial Services*, 112<sup>th</sup> Cong. (Feb. 15, 2011) (Testimony of Gary Gensler, Commodity Futures Trading Commission) available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/ChairmanGaryGensler/index.htm>.



**COMMUNICATIONS**

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## Appendix A

***Resolution on Financial Reform Legislation Affecting Over-the-Counter Risk Management  
Products and Its Impacts on Consumers***

**WHEREAS**, There is a diverse group of end-users, consisting of electric and natural gas utilities, suppliers, customers, and other commercial entities who rely on over-the-counter (“OTC”) derivative products and markets to manage electricity and natural gas price risks for legitimate business purposes, thereby helping to keep rates stable and affordable for retail consumers; *and*

**WHEREAS**, The United States Congress is considering financial reform legislation with the goal of ensuring that gaps in regulation, oversight of markets and systemic risk do not lead to economic instability; *and*

**WHEREAS**, Previous NARUC resolutions support federal legislative and regulatory actions that fully accommodate legitimate hedging activities by electric and natural gas utilities; *and*

**WHEREAS**, The proposed legislation would, among other things, provide the Commodity Futures Trading Commission (CFTC) with oversight of OTC risk management products, including mandatory centralized clearing and exchange trading of all OTC products; *and*

**WHEREAS**, Mandatory centralized clearing of all OTC contracts will increase expenses associated with hedging activity, and ultimately end-user prices, due to increased margin requirements; *and*

**WHEREAS**, A report by the Joint Association of Energy End-Users stated that the effect of margin requirements resulting from mandatory clearing for electric utilities would have the unintended effect of reducing or eliminating legitimate hedging practices and could jeopardize or reduce investments in Smart Grid technology; and for natural gas utilities and production companies could reduce capital devoted to infrastructure and natural gas exploration; *and*

**WHEREAS**, The laudable goals of reform that ensure market transparency and adequate regulatory oversight can be accomplished by means other than mandatory clearing of OTC risk management contracts and the anticipated extra expense. For example, a requirement that natural gas and electric market participants engaging in legitimate hedging report all OTC derivative transactions to a centralized data repository, like the CFTC, provides sufficient market transparency without the costs associated with mandatory clearing; *and*

**WHEREAS**, Proposed reforms would cause regulatory uncertainty with regard to the oversight of Regional Transmission Organizations (RTOs) and Independent System Operators (ISOs), where such uncertainty and/or overlapping jurisdiction can lead to negative impacts on liquidity, market confidence and reliability; *and*

**WHEREAS**, The Federal Energy Regulatory Commission (FERC), and the Public Utility Commission of Texas (PUCT) for Texas/ERCOT, as the regulators with the necessary expertise and statutory mandates to oversee electricity and natural gas markets to protect the public interest and consumers, should not be preempted by the financial reform legislation from being able to

continue exercising their authority to ensure reliable, just and reasonable service and protect consumers; *and*

**WHEREAS**, Energy markets currently regulated by FERC or the PUCT (for Texas/ERCOT) under accepted tariffs or rate schedules should continue to be subject to FERC's and the PUCT's (for Texas/ERCOT) exclusive Federal jurisdiction, including jurisdiction over physical and financial transmission rights, and market oversight; and should themselves not be subject to CFTC jurisdiction as a clearinghouse due to the financial and other settlement services they provide those transacting in regional electricity markets; *now, therefore be it*

**RESOLVED**, That the Board of Directors of the National Association of Regulatory Utility Commissioners, convened at its 2010 Winter Committee Meetings in Washington, D.C., supports passage of financial reform legislation ensuring that electric and natural gas market participants continue to have access to OTC risk management products as tools in their legitimate hedging practices to provide more predictable and less volatile energy costs to consumers; *and be it further*

**RESOLVED**, That new financial legislation being considered by Congress should weigh the costs of potential end-user utility rate increases versus the benefits of new standards for the clearing of OTC risk management contracts used by natural gas and electric utilities for legitimate hedging purposes; *and be it further*

**RESOLVED**, That any federal legislation addressing OTC risk management products should provide for an exemption from mandatory clearing requirements for legitimate hedging activity in natural gas and electricity markets; *and be it further*

**RESOLVED**, That any exemption to the mandatory clearing requirement for OTC derivatives be narrowly tailored as to not allow excessive speculation in natural gas and electricity markets; *and be it further*

**RESOLVED**, That the FERC, and the PUCT for Texas/ERCOT, charged with the statutory obligation to protect the public interest and consumers, should continue to be the exclusive Federal regulators with authority to oversee any agreement, contract, transaction, product, market mechanism or service offered or provided pursuant to a tariff or rate schedule filed and accepted by the FERC, or the PUCT for Texas/ERCOT; *and be it further*

**RESOLVED**, That NARUC authorizes and directs the staff and General Counsel to promote with the Congress, the Commodity Futures Trading Commission and other policymakers at the federal level, policies consistent with this statement.

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*Sponsored by the Committee on Gas, Consumer Affairs, and Electricity  
Adopted by the NARUC Board of Directors February 17, 2010*

## ***Resolution Addressing Excessive Speculation in Natural Gas Markets***

**WHEREAS**, Efficient natural gas markets based upon market fundamentals such as supply and demand, price transparency, and liquidity are necessary to ensure that the price consumers pay for gas accurately reflects the underlying value of the natural gas commodity; *and*

**WHEREAS**, The price of natural gas in U.S. commodity futures and physical markets rose to unprecedented levels in the summer of 2008 and the price increase occurred without a significant disruption in supply and in the midst of the greatest economic slowdown since World War II; *and*

**WHEREAS**, Even though natural gas prices are relatively low at the present time, the price currently being paid by consumers for natural gas is elevated due to local gas utilities having to purchase gas at the sharply elevated prices of the summer of 2008 for storage for current winter use; *and*

**WHEREAS**, Recent studies by the International Monetary Fund and the Massachusetts Institute of Technology Center for Energy and Environmental Policy Research argue that excessive speculation in the commodity futures markets has led to an increase in energy prices; *and*

**WHEREAS**, Natural gas is a major fuel for electricity generation and serves as an energy bridge to America's energy future. As such, high natural gas prices have a detrimental effect on the cost of electricity and all sectors of the American economy; *and*

**WHEREAS**, Regulated utilities that provide natural gas to 70 million U.S. homes and businesses for the basic human needs of space and water heating, cooking, and clothes drying utilize commodity futures markets to hedge their natural gas procurement costs in order to reduce the impact of natural gas price volatility on consumers; *and*

**WHEREAS**, Unlike natural gas utilities who access commodity futures markets for the purpose of mitigating price volatility through hedging, during the past five years other market participants have significantly increased their speculation in natural gas markets, with more than 90 percent of trades coming from market participants who do not intend to take delivery of the commodity; *and*

**WHEREAS**, Large amounts of money from speculators have entered natural gas futures markets such that the dollar value of open interest in natural gas futures has almost doubled, from a level of \$45 billion in 2006 to \$87 billion in 2008; *and*

**WHEREAS**, The Permanent Subcommittee on Investigations of the United States Senate held hearings in June and July 2007 examining the relationship between excessive speculation and high natural gas prices resulting in a staff report on how excessive speculation can and has distorted natural gas pricing and caused consumers to pay more for the commodity than is justified by market fundamentals; *and*

**WHEREAS**, At the 2008 Summer Committee Meetings, NARUC adopted a resolution sponsored by the Gas and Consumer Affairs Committees that called for the formation of a Working Group of NARUC Commissioners for the purpose of studying how excessive

speculation affects the price consumers pay for natural gas and making recommendations on whether NARUC should endorse the recommendations issued in the Staff Report of The Permanent Subcommittee on Investigations of the United States Senate issued in June 2007; *and*

**WHEREAS**, The Commodities Futures Trading Commission (CFTC) has the jurisdiction to protect market users and the public from fraud, manipulation and abusive practices related to the sale of commodity and financial futures and options and to foster open, competitive and financially sound futures and option markets; *and*

**WHEREAS**, The Permanent Subcommittee on Investigations of the United States Senate found that the CFTC did not have sufficient authority to regulate U.S. energy commodity markets, because it could not regulate the Intercontinental Exchange (ICE) to the same extent that it oversees the New York Mercantile Exchange (NYMEX); *and*

**WHEREAS**, The Permanent Subcommittee on Investigations of the United States Senate found that a single large hedge fund, Amaranth Advisors, LLC, was able to distort prices, increase volatility and increase costs to natural gas consumers in 2006, in large part by avoiding regulation and public scrutiny by conducting clandestine trading operations on the ICE; *and*

**WHEREAS**, The “Enron Loophole” exempts energy commodities traded on electronic energy exchanges such as ICE from regulatory oversight and severely limits both the Federal Energy Regulatory Commission’s (FERC) and CFTC’s ability to identify and prevent excessive speculation in natural gas markets; *and*

**WHEREAS**, The Permanent Subcommittee on Investigations of the United States Senate recommended eliminating the Enron Loophole, CFTC monitoring of positions held by traders on both the NYMEX and ICE, expanding the scope of efforts to detect excessive speculation, and increasing funding for the CFTC; *and*

**WHEREAS**, Research presented at congressional hearings by Michael Masters and Adam White contends that excessive speculation by commodity index traders may inflate the price of natural gas to the detriment of consumers; *and*

**WHEREAS**, The staff of the CFTC issued a report on Commodity Swap Dealers and Index Traders in September 2008 that found that determining the impact of commodity index traders is difficult due to existing reporting requirements for large traders; *and*

**WHEREAS**, Congress increased CFTC funding and granted it rulemaking authority to address the Enron Loophole through passage of the Food, Conservation, and Energy Act of 2008; *and*

**WHEREAS**, Recent problems in financial markets and comments from the Obama Administration will likely lead to comprehensive reform that may improve the ability of regulatory agencies to protect the public in addressing excessive speculation, fraud, manipulation, and abusive practices; *and*

**WHEREAS**, In January 2009, the Government Accountability Office issued a report entitled, *A Framework for Creating and Assessing Proposals to Modernize the Outdated U.S. Financial*

*Regulatory System*, that recommends changes in the way commodity futures and other financial derivative contracts often used in natural gas markets are regulated; *and*

**WHEREAS**, General reform of the financial regulatory system by Congress should include specific authority to address excessive speculation in natural gas markets; *now, therefore be it*

**RESOLVED**, That the Board of Directors of the National Association of Regulatory Utility Commissioners (NARUC), convened at its 2009 Winter Committee Meetings in Washington, D.C., encourages federal legislation adopting all of the recommendations presented in the June 2007 Staff Report of The Permanent Subcommittee on Investigations of the United States Senate; *and be it further*

**RESOLVED**, That NARUC supports the CFTC's efforts through rulemaking to completely eliminate the Enron Loophole, in order to provide more transparency in futures trading, as described in the June 2007 Staff Report of The Permanent Subcommittee on Investigations of the United States Senate; *and be it further*

**RESOLVED**, That NARUC supports new federal legislation to address the flow of investment capital into financial markets in ways that produce commodity price movements that are harmful to consumers, businesses, and financial markets; *and be it further*

**RESOLVED**, That NARUC supports proposals such as increasing margin requirements for futures contracts on speculators who do not intend to take delivery on essential commodities like natural gas and requiring over the counter natural gas derivative contracts to be cleared by exchanges as simple steps to combat excessive speculation; *and be it further*

**RESOLVED**, That any federal legislation and regulatory action addressing futures markets should fully accommodate legitimate hedging activities by electric and natural gas utilities as a strategy to manage the risk of price volatility and mitigate the price impacts of such volatility on consumers; *and be it further*

**RESOLVED**, That the Working Group should develop recommendations to address natural gas index speculation and report back to the Gas and Consumer Affairs Committees; *and be it further*

**RESOLVED**, That NARUC supports actions of the FERC and CFTC to increase supply and availability of natural gas and vigorous enforcement action against fraud, manipulation, and abusive practices, which could help reduce the commodity price of natural gas.

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*Sponsored by the Committees on Consumer Affairs and Gas  
Adopted by the NARUC Board of Directors February 18, 2009*