UNITED STATES OF AMERICA
BEFORE THE
DEPARTMENT OF THE TREASURY
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
FEDERAL DEPOSIT INSURANCE CORPORATION
FARM CREDIT ADMINISTRATION
FEDERAL HOUSING FINANCE AGENCY

Margin and Capital Requirements	)	Docket No. OCC-2011-0008 RIN 1557-AD43
For Covered Swap Entities	)	Docket No. R-1415 RIN7100 AD74
		RIN 3064-AD79
		RIN 3052-AC69
		RIN 2590-AA45

COMMENTS OF THE
AMERICAN GAS ASSOCIATION

Pursuant to the Notice of Proposed Rulemaking issued May 11, 2011,[1] by the Office of the Comptroller of the Currency, U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, the "Prudential Regulators"), the American Gas Association ("AGA") respectfully submits these comments. AGA believes that regulations implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] should ensure that the financial markets related to energy commodities function efficiently and protect the ability of commercial hedgers to engage in risk management activities for the benefit of American energy consumers at reasonable cost. AGA encourages the Prudential Regulators to work with the Commodity Futures Trading Commission ("CFTC") to develop a common approach to the margin requirements required of swap dealers and major swap participants, particularly as they apply to non-financial end-user counterparties.

[1] *Margin and Capital Requirements for Covered Swap Entities*, 76 Fed. Reg. 27,564 (May 11, 2011) ("Notice").
[2] Pub. L. No. 111-203 (July 21, 2010) ("Dodd-Frank Act").

I. COMMUNICATIONS

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

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II. IDENTITY AND INTERESTS

The AGA, founded in 1918, represents 201 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's members engage in financial risk management transactions with counterparties that may be considered swap dealers or major swap participants that are regulated by one of the Prudential Regulators. As such, AGA's members will be directly affected by regulations promulgated under the Dodd-Frank Act.

III. COMMENTS

A. Background

AGA member companies provide natural gas service to retail customers under rates, terms and conditions that are regulated at the local level by a state commission or other

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

regulatory authority with jurisdiction. Each year, natural gas utilities develop plans to reliably meet the gas supply needs of their retail customers. Gas utilities build and manage a portfolio of physical supply, storage and transportation services in order to meet anticipated demand. As such, gas utilities are commercial entities exposed to commodity risks, most especially the price of natural gas commodities. Gas utilities have a strong interest in managing these portfolios to ensure that the overall cost for natural gas service remains stable and at a reasonable cost to their customers. Price volatility presents significant challenges for both consumers and the gas utilities that serve them. Some gas utilities are required by state regulatory agencies to hedge a portion of forecasted demand to manage potential volatility.

In general, gas utilities forecast the anticipated demand on their systems and assess the underlying physical exposure associated with that demand. Many gas utilities then determine if financial instruments are needed to mitigate all or a portion of that exposure. In a recent survey, more than 90 percent of the AGA members responding to the survey indicated that they use financial instruments, including futures, options, and swaps, to hedge at least a portion of their gas supply purchases. Some gas utilities serve customers located far from major commodity trading hubs. Customized financial products may enable gas utilities to mitigate the volatility of natural gas commodity costs for those customers more effectively than standardized products linked to prices at a distant trading hub. In addition, some gas utilities 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. Customized financial products can allow a gas utility to increase or decrease hedging quantities to mitigate risks as customers migrate to or from unregulated retail marketers. These commercial hedging activities aid in reducing price volatility to end-use customers.

Gas utilities reduce the cost or hedges for their customers by relying, in part, on their strong financial profiles to obtain unsecured credit for their hedging transactions instead of posting cash collateral. Typically, entities owning gas utilities maintain a capital structure that is approximately 50 percent equity and 50 percent debt, and 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 financed through long-term debt. Gas utilities recover their costs, including the commodity-related costs of providing service, from their retail customers through rates approved by their local regulators. The commodity-related costs are recovered close in time to when the costs are incurred, *i.e.*, on a monthly basis. Moreover, to the extent customers do not pay their bills, utilities may be able to recover such costs through their rates either in the form of an expense included in base rates or through a monthly or quarterly cost recovery mechanism.

As a result of these strong credit profiles, gas utilities are able to negotiate with financial counterparties to take hedging positions up to a specified limit without having to post margin or collateral. Similarly, gas utilities often extend their counterparties a measure of unsecured credit as part of their hedging agreements, if justified by the counterparty's financial profile. Thus, the master agreements used by many gas utilities waive payment of initial margin, specify a minimum transfer amount in excess of $100,000, and/or permit netting of initial margin postings against margin postings for other transactions. These provisions recognize the strong credit profiles and limited default risk that gas utilities pose to their counterparties. Such credit arrangements benefit consumers by enabling counterparties to offer hedges to gas utilities at lower cost.

B. The Prudential Regulators' Proposal

The Prudential Regulators are proposing to establish capital and margin requirements for swap dealers and major swap participants that are regulated by one of the Prudential Regulators in accordance with Title VII of the Dodd-Frank Act. The Prudential Regulators propose rules that would permit a regulated swap entity to select one of two alternatives to calculate initial margin: (1) the swap entity may use a standardized table that specifies minimum initial margin expressed as a percentage of the notional amount of the swap; or (2) the swap entity may use an internal margin model that meets certain specified criteria that have been approved by the relevant Prudential Regulator.[4] The proposed rules generally require a regulated swap entity to collect variation margin periodically in an amount that is at least equal to the increase in the value of the swap to the regulated swap entity.[5] The Notice stated that the proposed rules establish minimum requirements and that nothing is intended to prevent or discourage a regulated swap entity from collecting margin in amounts greater than what is required in the rules.[6]

The proposed rules also specify the types of collateral that may be used to satisfy initial and variation margin.[7] Under the proposal, collateral is generally limited to immediately available cash funds; high-quality, highly liquid U.S. government and agency obligations; and certain government-sponsored ente rprise obligations subject to specified minimum "haircuts" for purposes of determining their value for margin purposes.[8]

With respect to commercial end users, the Prudential Regulators determined that, notwithstanding the legislative history, the plain language of the Dodd-Frank Act requires the

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[4] Notice, 76 Fed. Reg. at pp. 27,567-68.
[5] *Id.* at p. 27,568.
[6] *Id.*
[7] *Id.*
[8] *Id.*

Prudential Regulators to adopt rules for regulated swap entities to impose margin requirements on all non-cleared swaps, and that such language does not exclude a swap with a counterparty that is a commercial end user.[9] The Prudential Regulators stated, however, that given the lower risk of commercial end users, the proposed rules permit regulated swap entities to adopt, where appropriate, initial and variation margin thresholds below which a regulated swap entity is not required to collect initial and variation margin from counterparties that are end users.[10] Under the proposed rules, a regulated swap entity would not be required to collect initial or variation margin from a non-financial end-user counterparty as long as the regulated swap entity's exposure was below the credit exposure limits that the regulated swap entity has established under appropriate credit processes and standards.[11]

C. CFTC's Proposed Rules

In addition to the rules proposed in this proceeding, the CFTC has proposed rules establishing capital and margin requirements for swap dealers and major swap participants, albeit for those swap entities that are not regulated by one of the Prudential Regulators.[12] Under the CFTC's proposal, the proposed rules would not impose margin requirements for transactions between non-financial swaps entities and non-financial counterparties.[13] The CFTC believed that non-financial counterparties, that are using swaps to hedge commercial risk, pose less risk to non-financial swaps entities than financial counterparties.[14]

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[9] *Id.* at p. 27,569.
[10] *Id.*
[11] *Id.* at p. 27,570.
[12] *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 23,732 (Apr. 18, 2011); *Capital Requirements of Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 27,802 (May 12, 2011).
[13] 76 Fed. Reg. at p. 23,736.
[14] *Id.*

The CFTC's proposed rules would require that non-financial swaps entities have credit support arrangements in place providing that the entity may accept as margin from non-financial entities only assets for which the value is reasonably ascertainable on a periodic basis in a manner agreed to by the parties in the credit support arrangements.[15] According to the CFTC, the parties would be free to set initial and variation margin requirements at their discretion and any thresholds agreed upon by the parties would be permitted.[16] The CFTC's proposed rules would require each non-financial swaps entity to calculate hypothetical initial and variation margin amounts each day for positions held by non-financial entities to serve as risk management tools that would assist in measuring exposure and computing capital requirements.[17] Under the CFTC's proposal, if a non-financial swaps entity and a non-financial counterparty have agreed that the non-financial counterparty will post initial and variation margin, the rules provide flexibility as to the assets that are permissible, specifying simply that the value of the assets must be reasonably ascertainable on a periodic basis.[18] The CFTC would permit the use of non-cash collateral if consistent with preserving the financial integrity of the markets and preserving the stability of the U.S. financial system.[19]

D. Comments

As noted above, AGA has an interest in seeing that the financial markets related to energy commodities continue to function efficiently and allow commercial hedgers to continue to engage in risk management activities at reasonable cost. AGA is concerned that differences in the rules applicable to swap dealers and major swap participants that are regulated by the

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[15] *Id.*
[16] *Id.*
[17] *Id.* at pp. 23,737-78.
[18] *Id.* at p. 23,739.
[19] *Id.*

Prudential Regulators from those applicable to entities regulated by the CFTC may ultimately have a disruptive influence on the financial markets. Differences in regulation may lead market participants to engage in regulatory arbitrage in order to take advantage of such differences. Indeed, the differences in regulation may place one group of swap dealers and major swap participants at a competitive disadvantage in being able to offer financial hedging instruments to commercial end users potentially affecting liquidity and raising prices to consumers. Moreover, requiring counterparties to keep track of different sets of rules for swap dealers and major swap participants depending on which agency has regulatory jurisdiction may lead to unnecessary confusion and unduly complex contracting and compliance practices.

AGA, therefore, urges the Prudential Regulators to work with the CFTC to develop a common approach to capital and margin requirements for all swap dealers and major swap participants, particularly as they apply to non-financial, end-user counterparties. In that regard, AGA agrees that non-financial, commercial end users have lower risk profiles such that swap dealers and major swap participants should be permitted to enter into credit-based financial arrangements whereby initial and variation margin would not be required for counterparties that are non-financial, commercial end users, as proposed by the CFTC.

In addition, AGA is concerned that the proposed rules would require many non-financial, commercial end users to renegotiate their master agreements unnecessarily. As noted above, in recognition of the strong credit profiles and limited default risk of non-financial end users, many of the master agreements used by gas utilities waive payment of initial margin, specify a minimum transfer amount in excess of $100,000, and/or permit netting of initial margin postings against margin postings for other transactions. These provisions may have been obtained as a result of concessions that a swap dealer or major swap participant received on other contract terms. For instance, some gas utilities and their counterparties settle their transactions and post margin on a daily basis.

Requiring non-financial end users to adopt the contracting practices proposed in sections .3 through .5 would effectively require many gas utilities to renegotiate their master agreements, a time consuming and burdensome task. At the same time, following the standardized contracting approach proposed by the Prudential Regulators would not necessarily provide greater financial protection to swap dealers, major swap participants, or their non-financial end user counterparties than existing agreements. As highlighted above, non-financial end users and their counterparties have negotiated margining arrangements that reflect the credit profiles and default risks of the parties and the totality of the contractual relationship. Accordingly, AGA believes that the Prudential Regulators should continue to allow covered swap entities and non-financial end users to negotiate their own margining arrangements and not impose on such arrangements all of the contracting standards outlined in proposed sections .3 through .5.

AGA is also concerned that the collateral requirements of the proposed rules may be overly restrictive. Under section .8 of the Prudential Regulators' proposal, when collateral is required to be posted to meet additional or variation margin requirements, the forms of collateral are limited to immediately available cash funds, high-quality, highly liquid U.S. government and agency obligations, and certain government-sponsored enterprise obligations subject to specified minimum "haircuts" for purposes of determining their value for margin purposes.[20] As noted above, the CFTC has taken a different approach allowing a swap dealer or major swap participant to accept from a non-financial counterparty any collateral whose value is reasonably

[20] *Id.*

ascertainable on a periodic basis.[21] AGA urges the Prudential Regulators and the CFTC to adopt a common approach on acceptable forms of collateral. At a minimum, letters of credit should be permitted as an acceptable form of collateral.

In addition, the requirements applicable to initial margin modeling outlined in section .6 of the proposed rules may overstate the necessary amount of initial margin. In particular, the Prudential Regulators assume that non-cleared swaps will be less liquid and thus propose a minimum time horizon for the initial margin model of ten business days, compared with a typical requirement of 3-5 business days used by derivatives central counterparties.[22] As a result, the initial margin required by an acceptable initial margin model under the Prudential Regulators' proposal would be 2 to 2 ½ times higher for uncleared swaps than under current derivatives market. AGA sees no justification for requiring use of a 10-day liquidation period, and urges the Prudential Regulators to allow initial margin models to use a 3-5 business day time horizon.

Alternatively, section .8 of the proposed rules allows swap dealers and major swap participants to establish initial margin levels using the lookup table set forth in Appendix A of the Prudential Regulators' proposal.[23] Appendix A specifies that the initial margin requirement for commodities is 10-20 percent of notional exposure. Thus, the margin for energy swaps would be 20% of their notional value. AGA contends that the margin requirement for energy swaps would be too high and too costly, particularly as compared to the level of margin allowed for cleared and exchange-traded financial transactions, which are between five and ten percent of their notional value at present. Moreover, AGA contends that the Prudential Regulators and the CFTC should establish consistent requirements for initial margin models so as to reduce the

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[21] *See* 76 Fed. Reg. at p. 23,739.
[22] 76 Fed. Reg. at p. 27,579.
[23] *Id.* at p. 27,572.

potential for regulatory arbitrage. Accordingly, AGA urges the Prudential Regulators to work with the CFTC to establish consistent requirements for initial margin models that include a lower percent of notional exposure for swaps in the commodity asset class.

IV. CONCLUSION

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

Respectfully submitted,

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