November 20, 2012

Submitted Electronically

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Board of Governors
of the Federal Reserve System
20th Street and Constitution Avenue NW.
Washington, DC 20551

Robert E. Feldman, Executive Secretary
Attention: Comments
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550 17th Street NW.
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Office of the Comptroller of
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Office of Regulatory Policy
Farm Credit Administration
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McLean, VA 22102–5090

Alfred M. Pollard, General Counsel
Attention: Comments/RIN 2590–AA45
Federal Housing Finance Agency
Eighth Floor, 400 Seventh Street SW.
Washington, DC 20024

Re: Margin and Capital Requirements for Covered Swap Entities; Reopening of Comment Period:
Board of Governors of the Federal Reserve System: Docket No. R–1415
Federal Deposit Insurance Corporation: RIN 3064–AD79
Farm Credit Administration: RIN 3052–AC69
Federal Housing Finance Agency: RIN 2590–AA45
The American Public Gas Association (“APGA”) appreciates the opportunity to submit an additional comment on the Agencies’ proposed margin and capital requirements for swap dealers and major swap participants. The Agency Proposal proposes to implement margin and capital requirements for uncleared swaps as required by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) for certain swap dealers (“Swap Dealers” or “SDs”) and major swap participants (“MSPs”). The Extension Notice is intended to provide interested parties the opportunity to comment on the Agency Proposal in light of the recently-issued consultative paper on margin requirements for uncleared swaps issued jointly by the Basel Committee on Banking Supervision (“BCBS”) and the International Organization of Securities Agencies (“IOSCO”).

I. Introduction

APGA’s comments herein are addressed exclusively to the treatment of certain commodity swaps used to hedge municipal prepayment transactions for the supply of long-term natural gas or electricity (“Municipal Prepayment Transactions”). Municipal Prepayment Transactions have provided significant benefits to municipal utility systems and their customers across the United States for close to 20 years. As described in detail below, these transactions are facilitated by a unique form of matched commodity swaps that allow the parties to a Municipal Prepayment Transaction to hedge their respective exposures to the changing price of the natural gas underlying the transaction with a single Swap Dealer. Each pair of matched commodity swaps is non-standardized and accordingly will not be cleared. All the material terms, notional quantities, tenor, and pricing points of the matched swaps are the same. They expressly contain no mark-to-market credit exposure to participants upon either early termination or replacement events. The matched swaps thus economically offset each other in every way, including that neither will survive the termination of the other. Under the structure of the Municipal Prepayment Transactions, neither swap will survive the termination of the prepayment transaction, and the prepayment transaction will not survive if both commodity swaps do not remain in place. Accordingly, there is no counterparty, safety and soundness, or systemic risk associated with the matched commodity swaps in Municipal Prepayment Transactions.

While the counterparty to one of the swaps (the “front-end” swap) in a Municipal Prepayment Transaction is always a nonfinancial end user (it is typically a governmental gas supply agency), the counterparty to the other swap (the “back-end” swap), the prepaid gas supplier, may be a swap entity or other financial entity. Both the governmental gas supply

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4 Similar arrangements and issues exist for prepayments of gas and electricity supply. For simplicity, our comment focuses primarily on municipal prepayment agreements for long-term natural gas supplies, but our concerns are equally applicable to electricity supply.
agency and the prepaid gas supplier enter into the matched swaps for the sole purpose of hedging their commercial risk. Therefore, they both act as commercial end users in connection with the matched swaps. APGA thus believes that the prepaid gas supplier should be treated the same as a commercial end user for purposes of margin and capital in connection with these swaps and that neither should be required to post margin except as may be separately negotiated between the parties.

As APGA discussed in its earlier comment letter, the Agency Proposal generally appears to require each covered swap entity to establish minimum thresholds for each counterparty, including nonfinancial end user counterparties exempt from mandatory clearing, based on a determination of the creditworthiness of the counterparty. The covered swap entity must collect initial and variation margin for all transactions with the counterparty in which the exposure exceeds the threshold, including from end users entering into swaps to hedge risk. In addition, the Agency Proposal requires each covered swap entity to take a capital charge for all of its uncleared swaps. In our earlier comment, we urged the Agencies to ensure that their final margin rules are consistent with those of the Commodity Futures Exchange Commission (“CFTC”), which made clear in its margin proposal that covered swap entities would not be required to collect initial or variation margin from their nonfinancial end user counterparties. We believe that the CFTC’s proposal with respect to nonfinancial end users is consistent with the mandate of and intent behind the Dodd-Frank Act. We noted in our earlier letter that the CFTC approach would permit covered swap entities and nonfinancial end users to set the terms of any initial and variation margin requirements in their own discretion pursuant to their credit support agreements without any regulatory mandates. We again urge the Agencies to ensure that their final rules do not mandate the collection of margin from nonfinancial end users and to extend that treatment to both matched swaps in a Municipal Prepayment Transaction.

As we explain in this letter, the two matched swaps in a Municipal Prepayment Transaction economically off-set and expressly have no mark-to-market exposure in the event of early termination or replacement. To preserve this balance, it is critical that both sides of the pair be subject to the same margin treatment. The imposition of mandated margin requirements on either of the matched swaps on the basis of mark-to-market calculations as if the swap did not “tear up” upon early termination or replacement would be cost-prohibitive, as would the passing along by the swap entity of any capital charges associated with the matched swaps. Moreover, none of these additional costs would provide any additional credit protection.

We understand and support the goal of ensuring reasonable credit safeguards in the derivatives arena. Nonetheless, we are concerned that the credit-safe and consumer-beneficial Municipal Prepayment Transactions, which because of their public importance are protected under the Internal Revenue Code, could inadvertently be seriously harmed absent clarification that neither side of the matched swaps that hedge these transactions will be required to post or collect margin in connection with the matched swaps.

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6 See discussion below at III.A.
For the reasons set forth in our initial comment letter, we restate our belief that Section 731 of the Dodd-Frank Act does not require the Agencies to impose margin or capital costs on a commercial end user by imposing such costs on transactions in which that end user is a counterparty. We also believe that the Agencies have the authority under the statute not to require margin for swaps that hedge commercial risk and that themselves involve no risk and pose no threat to the safety and soundness of a swap entity even where a counterparty is not a nonfinancial end user. Therefore, APGA requests that the Agencies either expressly exempt both sides of the matched commodity swaps described below from their margin requirements or otherwise clarify that no margin will be required in connection with these paired swaps other than any margin that might be required pursuant to negotiated credit support arrangements between the parties. For the same reasons, APGA also requests that the Agencies make clear that additional capital will not be charged in connection with these swaps.

II. APGA

APGA is the national association of publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and approximately 700 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities. In addition, APGA’s membership includes, as agency members, a number of governmental entities that do not own retail distribution systems but rather have been formed by municipalities under state law as joint action gas supply agencies, for the purpose of acquiring long-term gas supplies for municipal gas distribution systems and managing their transportation and storage on the interstate pipelines. Such joint action gas supply agencies are typically the parties to Municipal Prepayment Transactions to acquire long-term gas supplies at reasonable and competitive prices on behalf of and for the benefit of their municipal members. Our members and agency members are nonfinancial end users under the Dodd-Frank Act and thus will generally have available to them the end user exemption from clearing established by Section 731.

Public gas systems depend upon Municipal Prepayment Transactions to meet the natural gas needs of their consumers. However, if either public gas systems or prepaid gas suppliers are required to post margin (or capital) to cover the tenor of these matched swaps as if they were not “tear-up” swaps, it would be prohibitively expensive for them to enter into the swaps. The parties will not enter into Municipal Prepayment Transactions at all if they are unable to hedge their long-term price exposure under the prepaid gas contract.
III. Municipal Prepayment Transactions and Matched Commodity Swaps

A. Municipal Prepayment Transactions

A Municipal Prepayment Transaction for natural gas is a set of contractual undertakings in which a governmental natural gas supply agency or its special purpose corporate instrumentality (a "gas agency") acquires a long-term supply of natural gas to meet the needs of retail gas consumers served by publicly-owned gas distribution systems or to generate electricity used by retail consumers of a municipal electric distribution system.

Under a Municipal Prepayment Transaction, the gas agency makes a lump sum advance payment (funded through an issuance of tax-exempt bonds) to a gas supplier for a predetermined quantity of natural gas, to be delivered in predetermined daily amounts at predetermined points of delivery pursuant to a long-term contract, typically 20 or 30 years in duration (the "Prepaid Gas Agreement").

Municipal Prepayment Transactions were developed by public gas systems to enable them to acquire a portion of their supplies on a long-term basis both to provide supply security and, by taking advantage of their ability as state and local governmental entities to issue tax-exempt bonds, to acquire such supplies at a discount to prices that they would otherwise pay in the market.

Municipal Prepayment Transactions financed with tax-exempt bonds are governed by U.S. Treasury Regulations, which provide that prepayment contracts that meet certain guidelines are not to be deemed a loan to the prepaid gas supplier and, consequently, are not subject to the arbitrage rules of Section 148 of the Internal Revenue Code. As part of the Energy Policy Act of 2005, Congress established a safe harbor under the Internal Revenue Code for Municipal Prepayment Transactions for natural gas (but not electricity) that meet the guidelines set forth in the statute.

Debt service on the bonds results in a fixed cost per unit for the prepaid gas supplies. However, the sale price from the gas agency to its municipal gas distribution customers is referenced to market prices. Similarly, the purchases of gas supply by the prepaid gas supplier to meet its delivery obligations are at market prices, while its investment of the prepayment generally results in a fixed return that may be more or less than the cost of gas purchases. Thus the gas agency and the prepaid gas supplier both need to have their net cost of or revenue from the gas supplies reflect market prices, not fixed prices.

B. Hedging the Exposures from the Municipal Prepayment Transaction

The gas agency and the prepaid gas supplier both have exposure in the same notional quantities (the delivery quantities under the Prepaid Gas Agreement), for the same time period (the term of the Prepaid Gas Agreement), and at the same delivery points. Consequently, each is the natural party to enter into a commodity price swap transaction with the other. However, Section 1.148-1(e)(iii)(E) of U.S. Treasury Department Regulations by implication precludes the buyer and seller from swapping prices with each other directly. Accordingly, to hedge their exposure to the variability of market prices as compared to the fixed price inherent in the Municipal Prepayment Transaction, the gas agency and the prepaid gas supplier enter into matched commodity swaps. These are separately entered into by the gas agency and the prepaid
gas supplier with the same third party commodity swap counterparty in order to enhance efficiency and reduce costs.

Because the two swap agreements are matched as to notional quantities, term, and pricing points, they are referred to as the “front-end” swap (between the gas agency and the commodity swap counterparty) and the “back-end” swap (between the prepaid gas supplier and the commodity swap counterparty). The bid-offer spread for the fixed price between the front-end and back-end swaps is the counterparty’s fee for undertaking the role of swap counterparty.

The front-end commodity swap agreement provides for the payment by the gas agency of the floating index price each month on the notional volumes for that month and the payment by the commodity swap counterparty of the fixed price on the notional volumes for that month. The back-end commodity swap agreement provides for the payment of a fixed price (equal to the fixed price paid by the commodity swap counterparty under the front-end swap plus the bid-offer spread) by the prepaid gas supplier and the payment by the commodity swap counterparty of the same floating index price for the same notional volumes at the same pricing point as under the front-end swap.

C. Termination of the Matched Commodity Swaps

The structure of the Municipal Prepayment Transaction requires matched commodity swap agreements to remain in place at all times, since the variable prices paid by the gas agency’s municipal utility customers would not be sufficient to pay its debt service in a low price environment without payments under its swap. If either of these agreements terminates early and the commodity swap counterparty is not replaced by a new commodity swap counterparty for both the front-end and the back-end swaps, the Prepaid Gas Agreement terminates early. Similarly, if the Prepaid Gas Agreement terminates early pursuant to its terms, both matched commodity swap agreements also terminate. As a practical matter, there are no circumstances under which one of the commodity swap agreements would remain in place while the other has been terminated early.

Early termination of a commodity swap agreement results in no payment of damages or any mark-to-market payment by either party to the other. Only amounts accrued under the commodity swap agreement for performance to the early termination date are payable upon its early termination. Accordingly, the commodity swap agreements are referred to as “tear-up” swaps. There is never any mark-to-market exposure borne by any of the three parties – the gas agency, the prepaid gas supplier, or the commodity swap counterparty – under the matched commodity swap agreements.

IV. Matched Commodity Swaps Entered Into to Hedge Municipal Prepayment Transactions Should Not be Required to Post Margin and Should Not be Subject to Incremental Capital

As discussed in our earlier comment, APGA urges the Agencies to adopt the same approach as the CFTC has proposed with respect to nonfinancial end users. Specifically, we ask that the Agencies’ final rules make clear that such end users will not be required to post initial or variation margin for transactions with SDs or MSPs beyond any margin that might be required pursuant to negotiated credit support arrangements between the parties.
The gas agency in a Municipal Prepayment Transaction is always a nonfinancial end user. The prepaid gas supplier and the commodity swap counterparty, however, could be swap entities or other financial entities. To ensure that the matched pair of swaps would be subject to the same margin treatment, we ask that the Agencies also make clear that margin will not be mandated for prepaid gas supplier counterparties to Municipal Prepayment Transactions even if they are financial entities.

### A. Both Matched Swaps in Municipal Prepayment Transactions Should be Exempted

Because the matched commodity swaps are mirror images of each other and are economically identical, they should be accorded the same regulatory treatment. Their “tear-up” nature underscores that they contain no inherent or residual risk and thus do not raise systemic or safety and soundness risks. Thus, both the gas agency and the prepaid gas supplier should be exempted from the margin requirements in connection with the matched commodity swaps (other than any margin that might be required pursuant to negotiated credit support arrangements between the parties), even if one of them is a swap entity or other financial entity.

The Agencies recognize that commercial end users pose only “minimal risks” to the safety and soundness of covered swap entities and U.S. financial stability. They also recognize that not all financial counterparties pose the same level of risk. However, their proposal focuses primarily on the nature of the counterparty rather than on the level of risk posed by the transaction. We ask that the Agencies also recognize that certain transactions that pose no risk and that also serve crucial public purposes, such as Municipal Prepayment Transactions, should be exempt from mandatory margin requirements.

We note that the CFTC’s approach to risk mitigation in connection with swaps does expressly recognize that swaps used to hedge commercial risk, even when used by a swap entity or other financial entity, do not raise the same concerns as swaps that are not used for such hedging. Accordingly, under the CFTC’s swap entity rules, swaps used to hedge physical positions or otherwise mitigate commercial risk do not have to be counted in an entity’s determination of whether it is an SD.

Similarly, the CFTC has permitted potential MSPs to exclude from the MSP determination certain swaps used for hedging commercial risk because it explicitly recognizes that counting swaps used for speculation, trading, or investment “will be sufficient to limit financial entities’ ability to engage in risky transactions,” thereby rendering the counting of swaps used to hedge unnecessary.

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8 The CFTC adopted as an interim final rule Regulation § 1.3(ggg)(6)(iii), which provides that the determination of whether a person is an SD will not take into account any swap entered into for the purpose of offsetting or mitigating the person’s price risks that arise, among other things, from the potential change in the value of one or several commercial assets or services that the person provides or anticipates providing, as long as certain conditions, designed to ensure that the swap is for legitimate commercial purposes and not to evade designation, are met.
APGA believes that a similar approach is appropriate for the matched commodity swaps at issue here and that no initial or variation margin should be required for matched commodity swaps entered into in connection with Municipal Prepayment Transactions as described above, regardless of whether the parties are nonfinancial entities, or SDs, MSPs, or other financial entities.\textsuperscript{10}

**B. The Agencies are Authorized to Grant the Exemption**

The Agencies are authorized under Section 731 of the Dodd-Frank Act to determine the amount of margin to be applied to a particular type of swap transaction.\textsuperscript{11} Indeed, the statute requires that the amount of margin be calibrated to the risk of the uncleared swap. The margin must be designed to help ensure the safety and soundness of the SD or MSP and also be "appropriate for the risk associated with the non-cleared swap" held as an SD or MSP.\textsuperscript{12} The Agencies recognize in the Proposed Rule that the statute requires them to take a risk-based approach to establishing margin requirements.\textsuperscript{13} The matched commodity swaps at issue here pose no risk because they are matched in price, notional value, term, and termination conditions. In the event of a default, the swaps are simply "torn up." Accordingly, the Agencies should exempt these matched commodity swaps from mandatory margin.

**C. Importance of Exemption**

Since their inception in the 1990s, Municipal Prepayment Transactions hedged with matched commodity swaps have served the twin purposes of providing long-term, secure gas supplies to municipal energy systems for sale to their customers for space heating, water heating, cooking, and other domestic, commercial, and industrial uses, and providing the gas at reasonable and competitive prices. As credit concerns have washed over the economy in recent years, these transactions have continued to provide secure gas supplies without the risk of the imposition of increased payment security obligations over time.\textsuperscript{14} There is no question that Municipal Prepayment Transactions further important social and economic goals.

Margin requirements could make the matched commodity swaps prohibitively expensive for the commercial and financial entity counterparties and could render them largely unavailable for gas agency end users. Without the ability to hedge price fluctuations, APGA's members and agency members would not be able to continue to enter into Municipal Prepayment Transactions for natural gas, a consequence that is simply not appropriate for or justified by the absence of risk inherent in the matched commodity swaps.

\textsuperscript{10} As noted above, one side of the matched pair of swaps is always a commercial end user, such as a gas agency.

\textsuperscript{11} The Agencies are also required to set margin for covered swap entities engaging in security-based swap transactions, under Section 764 of the Dodd-Frank Act. Our comments do not address security-based swaps or Section 764 authorities.

\textsuperscript{12} CEA Section 4s(e)(3)(A).

\textsuperscript{13} Proposed Rule, 76 Fed. Reg. at 27569.

\textsuperscript{14} After Congress and the Federal Energy Regulatory Commission ("FERC") deregulated the purchase and sale of natural gas at the wholesale level in 1993, all gas distribution systems, public and private, began to be required to purchase all of their gas supplies under negotiated contracts. Gas pipelines thus went from providing bundled "citygate" service to being transporters, and the public gas distribution systems went from being purchasers of delivered gas supply at regulated prices to being purchasers of deregulated commodity supplies in the field and shippers under regulated transportation contracts.
Accordingly, these swaps should either be expressly exempted from margin requirements or the Agencies should clarify that the initial and variation margin for these matched commodity swaps in connection with Municipal Prepayment Transactions will be set at zero, or as negotiated by the parties.

V. Capital Also Should Not Be Required for Matched Commodity Swaps in Connection with Municipal Prepayment Transactions

APGA’s earlier comment letter also raised concerns about the potential impact of the Agencies’ proposed capital rules on nonfinancial end users. We reiterate those concerns in relation to the matched commodity swaps at issue here. Even if margin is not required for these swaps, the counterparties to the matched commodity swaps will face increased costs to the extent that the proposed rules would apply a capital charge to the covered swap entity in connection with the matched swaps. APGA is concerned that the swap entity will simply pass on these increased costs to the gas agency and gas supplier, which will, as discussed above, impede their ability to enter into Municipal Prepayment Transactions.

APGA therefore respectfully requests that the Agencies modify their proposed approach to capital to make clear that transactions involving matched commodity swaps used in connection with Municipal Prepayment Transactions should not incur any direct or indirect capital charge.

VI. Conclusion

As we have noted in the past, natural gas is a lifeblood of our economy and millions of consumers depend on natural gas every day to meet their needs. APGA has long been supportive of regulatory efforts to bring greater transparency to the over-the-counter swaps markets, including implementing measures designed to reduce risk, increase transparency and promote market integrity within the U.S. financial system. We appreciate the efforts to build a comprehensive framework on the foundation of the Dodd-Frank Act.

It is critical that APGA’s members and agency members be able to continue to hedge their commercial risks within this framework without incurring undue and unnecessary additional costs. APGA thus urges the Agencies to make clear that margin may not be imposed on either counterparty in connection with matched commodity swaps that are used to facilitate Municipal Prepayment Transactions as described above. In addition, we ask that the Agencies alter the proposed capital rules as necessary to protect all counterparties to matched commodity swaps used in connection with Municipal Prepayment Transactions from additional capital charges. Only in this way can APGA’s members and agency members continue to reduce their exposure to commercial risk and provide their customers with natural gas at affordable stable rates.

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We would be happy to discuss our comments at greater length with the staff. Please feel free to contact Bert Kalisch, President and CEO of APGA, or David Schryver, Executive Vice President of APGA, at 202-464-2742, or Paul M. Architzel of Wilmer Cutler Pickering Hale and
Dorr LLP at 202-663-6240 or Jim Choukas-Bradley of Miller, Balis & O’Neil, PC at 202-296-2960, outside counsel to APGA.

Respectfully submitted,

[Signature]

Bert Kalisch,
President and CEO