

Impact of Treasury's OTC Derivatives Legislation on Commodity Derivatives

Commodity derivatives were first developed to help farmers hedge price risks of agricultural commodities. Today, both exchange and OTC venues serve primarily as risk management tools for a wide range of participants trading in many different products and local markets.

Risk Reducing Characteristics of the OTC Commodity Derivatives Market

The OTC commodity derivatives market consists of diverse market participants that trade numerous underlying products. It is a mature¹ market with a strong, stress-tested risk management infrastructure that, as a result of market-led initiatives, already provides for clearing solutions where suitable.

Commodities market participants consists of commercial producers and manufacturers including corporate and government producers and consumers, regional and local energy distribution and/or supply companies, international energy firms, specialized energy traders, power producers, banks and investment firms that are hedging their commercial risks. This diversity of market participants is a key factor in mitigating the type of counterparty credit risk that may lead to broader risk.

Market participants trade in several different market segments including gas, base metals, precious metals, power, plastics products, oil products, crude oil, coal, freight, agriculture, emissions and weather and therefore is not concentrated in any one particular product. Different segments use different types of documentation and methods of settlement, and some are more customized than others.

In this market, a significant percent of commodity swaps that are suitable to be centrally cleared are already being efficiently processed and cleared. Based on monthly metrics provided by major dealers, over 27% of their OTC Commodity Derivatives are settled via central counterparties.

Other market-led initiatives include monthly reporting on a number of key performance indicators, a 65% decrease in the gross number of outstanding confirmations since September 2008 and an increase in the average percentage of total volume that is electronically eligible from 52% (Dec 07) to a high of 79% (August 09).

In fact, commodity firms have performed robustly through the current crisis and there have been no cases so far in which commodity derivatives contributed to putting the financial system at risk. Broad proposals that fail to consider these risk mitigating features do not adequately reflect the activity and risk profile of the OTC commodity derivatives market.

¹ It should be highlighted that while certain aspects of the commodities transaction risk management and clearing infrastructure are mature, certain aspects of the Treasury's proposal are well beyond the level of market development. This is particularly true as it relates to the practical issues associated with electronic execution. The relative level of market development for electronic execution is notably less developed than the interest rate and foreign exchange markets, and to the extent it does exist in the commodity markets, it is very narrowly developed across a small number of instruments/contracts, and only in limited markets such as oil and natural gas.

The Proposal - Significant Impacts

The Proposal² would significantly affect the commodity derivatives markets and products that are used as risk management tools by companies. Several of these significant impacts are discussed below.

Impact 1: The Proposal would increase market risk because customized commodity derivatives would become less available.

Regulatory-directed standardization and mandatory central clearing and exchange trading could actually increase risk by limiting the use of OTC commodity derivatives and the ability to develop new risk management products. Dealers would be discouraged from offering customized products or would be required to offer them at prohibitively high costs. This would undermine the Administration's priority to enhance the risk management capabilities of financial institutions and their counterparties.

Less access to customized commodity derivatives would, in turn, lead to ineffective hedging and incomplete transfer of risk because standardized swaps would only allow certain amounts, dates or commodities to be traded, leaving end users with basis risks³ they don't want and can not manage effectively. The Proposal sets up a trade-off between arguably reducing counterparty credit risk for certain cleared standardized swaps and increasing basis risk by encouraging the use of those cleared standardized swaps to cover underlying risks on a mismatched basis.

- For example, in the commodities market, average price derivatives are only available in OTC markets, where a commercial end-user who buys corn daily can use OTC derivatives to pay the average price for that commodity during the exact period of protection. This transaction would allow that commercial end-user to mitigate the risk of overpaying for protection, avoid exposure to uncovered risk, and give a more stable and predictable price to customers.

Impact 2: The Proposal's vague language would increase market risk because end users may elect to hedge their risk less frequently due to legal uncertainties.

There is a great deal of uncertainty around the Proposal's definition of "major swap participant" and the exception to mandatory clearing's reference to a DCO's "eligibility requirements".

"Major swap participant" is vaguely defined as any person who is not a "swap dealer" who maintains a substantial net position in outstanding swaps, other than to create and maintain an effective hedge under GAAP. Some of the key questions raised by this language include how "substantial net position" or any change in "net position" will be determined, whether the narrow GAAP standard for hedging will unintentionally sweep in end users that use OTC commodity derivatives for risk mitigation purposes but

² The Annex hereto provides an overview of the Proposal.

³ Basis Risk is generally defined as the risk that offsetting investments in a hedging strategy will not experience price changes in entirely opposite directions from each other. This imperfect correlation between the two investments creates the potential for excess gains or losses in a hedging strategy, thus adding risk to the position.

that may not otherwise qualify for GAAP hedge accounting treatment, and whether end users will be considered major swap participants for all of their derivative positions.

- For example, a commodity market participant may be considered a major swap participant with respect to its commodities activities, but may use interest rate swaps only infrequently to hedge its funding costs. Designating such a commodity market participant as a major swaps participant with respect to its use of interest rate derivatives could seriously hamper its ability to hedge financial risks.

Persons designated as Major Swap Participants will face costly barriers to entering into OTC derivative transactions, including, but not limited to, mandatory clearing of all "standardized" OTC swaps, capital and margin requirements and undefined reporting, recordkeeping and other corporate governance responsibilities.

In addition, an end user that is not deemed to be a regulated entity may nonetheless be subject to mandatory clearing if such end user meets the "eligibility requirements" of any DCO. It is unclear whether the reference to "eligibility requirements" is intended to refer to those requirements that clearinghouses establish only for their clearing members or whether it also refers to eligibility criteria for customers. To the extent the term "eligibility requirements" is intended to encompass customer eligibility requirements, the Proposal could potentially sweep in any periodic end-user of OTC derivatives.

Requiring smaller commodity market participants, who deal in lower volumes and transact contracts less frequently, to develop and operate complex processes in this context would impose a heavy compliance burden, with little benefit in terms of mitigation of systemic risk. This could inhibit or possibly even preclude many commodity market participants from using OTC commodity derivatives to hedge their risks.

Impact 3: The Proposal would increase market risk because end users would hedge less due to increased costs related to capital and margin requirements.

The Proposal would impose capital requirements on regulated entities for both cleared and non-cleared commodity swaps with the requirements for non-cleared commodity swaps set at a higher level than those for cleared commodity swaps. The Proposal also provides the agencies with broad discretion to impose both initial and variation margin requirements on counterparties that enter into transactions with a regulated entity. It is unclear whether margin will be determined on a notional or net basis. While there is an exception to the margin requirements, the exception is based on the narrow GAAP definition of "hedge" and requires that one of the counterparties not be a regulated entity and not be predominantly engaged in financial activities.

As an initial matter, imposing capital and margin requirements on non-financial companies would seem to be very difficult and may result in significant unintended consequences such as causing liquidity or working capital contractions or incentivizing end users to abandon otherwise beneficial hedging transactions. Currently, many small and mid-sized companies that are only occasional users of commodity derivatives elect to use OTC swaps because of the costs and demands of managing margin requirements on a daily basis. Significantly increasing the costs associated with using OTC derivatives will hamper the ability of small- and mid-sized companies to manage their risks.

Impact 4: The Proposal would increase earnings volatility because standardization would make it difficult for companies to achieve hedge effectiveness and qualify for hedge accounting.

Exchange-traded contracts do not allow customization to the specific amounts, dates or rates to be traded. Therefore, standardization can lead to ineffective hedging and incomplete transfer of risk. By contrast, tailor-made commodity derivatives allow companies to achieve "hedge effectiveness" and qualify for hedge accounting.

Companies seek to employ hedge accounting to reduce earnings volatility related to both core and non-core business activities. Derivatives related to core business activities could include, for example, fixed commodities pricing contracts. Companies that do not qualify for hedge accounting must mark derivatives to market and record gains and losses in their income statement, therefore creating undesired earnings volatility in their financial statements. Even when a company qualifies for hedge accounting, any hedge ineffectiveness is supposed to be reflected in earnings.

The Proposal - Unintended Consequences of Implementation

Adopting the Proposal could result in several unintended consequences in the commodities markets and the economy. Several of these unintended consequences are discussed below.

Consequence 1: Higher costs and less certainty around hedging activity can lead to higher prices and greater price volatility in commodity markets.

As noted above, the Proposal increases hedging related costs at nearly every stage of the life cycle of commodities markets from production to end use. These additional costs of doing business (and managing associated risk) likely will be passed along to end users in the form of higher prices.

Additionally, the increased cost and/or unavailability of suitable hedging mechanisms may encourage producers to reduce production, potentially resulting in less supply in the marketplace and higher prices to meet associated demand. Furthermore, the potential lack of suitable hedging mechanisms can lead to significantly more volatile and cyclical prices in order to incentivize enough capital to flow into the industry in response to exaggerated price signals.

- This is currently the case in certain energy related markets where liquid hedging mechanisms are not presently available (i.e., chemicals and plastics) and the Proposal has the potential of creating this behavior in other markets (i.e., certain natural gas markets).

Ultimately, commodity swaps mitigate volatility and encourage production in the commodity markets because they enable commercial producers to hedge their price risks. Therefore, increasing the costs associated with using OTC commodity derivatives will have severe consequences to consumers, who expect stable, affordable commodity prices.

Consequence 2: Establishing position limits coupled with restricting existing hedge exemptions may harm the commodities market.

Depending upon where prices are at any given moment, commercial hedgers seeking to buy and those seeking to sell are rarely motivated to do so at the same time. Without the ability to use the futures markets as a hedge of trading activity with noncommercial parties, dealers will need to curtail their participation in the OTC commodities markets in order to avoid the risk of too much exposure to one side of the market due to the participation by either the commercial buyers or sellers at any one point in time. As a result, the commodity markets will be harmed due to increased volatility, particularly in the front months; impairment of market liquidity; widening of spreads and increased costs in hedging; and restricted hedging capability of commercial and noncommercial entities.

Consequence 3: The Proposal would impede business growth due to the diversion of working capital to margin accounts and regulator-set capital requirements.

The OTC commodity derivatives market is more flexible in credit terms, credit thresholds and amounts and types of collateral that can be applied. Counterparty credit risk is effectively managed by various types of collateral arrangements as well as other common methods of assurance including parent company guarantees, pledge of assets, prepayments and letters of credit.

The ability to custom-tailor OTC derivatives along with the flexibility to manage corresponding counterparty credit risk with assets other than cash is essential to long term planning for large capital projects. In instances where cash is unavailable or uneconomical, without access to the current OTC market many projects simply will not get built. Consider:

- A power plant developer is seeking bank loans to finance a natural gas power plant. Typical loan requires that inputs (i.e. fuel and carbon) be hedged. The developer could try to hedge on an exchange, but contracts with the needed size, duration and terms will very likely be unavailable. Even if proper contracts available, the developer must post cash collateral. Outcome: The developer uses the OTC market, achieves precise hedge of its risk thru customization, posts first or second lien on the power plant, frees up cash.

- A power plant developer routinely buys natural gas to produce electricity. Any time natural gas prices rise, it needs more money. The developer could go to a bank for a revolving line of credit, but that is an expensive alternative because the developer would have to pay a standing fee, even if it does not use the line of credit. Instead, the developer enters into a customized commodity price swap linked to the price of natural gas. Outcome: By engaging in the customized commodity price swap, the developer avoids incurring indebtedness and paying the standing fee, which makes capital available for other purposes.

The Proposal would apply rigid capital and margining requirements even to commodity cash-poor markets in a time when credit is extremely tight. End users will be subject to regulator-set margin requirements on their OTC commodity swaps regardless of potential mitigating factors such as counterparty credit risk assessment or the size and duration of the swap. Daily margining of collateral would also add significant administrative costs that would disadvantage smaller market participants. Together with the clearing mandate, which would require the use of cash as collateral, the Proposal would result in American companies using working capital to fund margin accounts.

Among other concerns, it is not clear why regulated entities, in effect, should be forbidden from extending credit to counterparties since this is conceptually no different from their core credit-risk business. It is also unclear whether collateral requirements will be tailored to meet the specific liquidity needs of commodity markets by, for example, allowing a diverse range of acceptable collateral. As it stands, the Proposal would simply replace credit risk with liquidity risk, at a massive cost to end users.

Consequence 4: The Proposal would create legal uncertainty in the physical energy markets and could subject markets already subject to jurisdiction by energy regulators to duplicative and overlapping CFTC jurisdiction.

The Proposal exempts forward contracts where physical delivery of a commodity occurs. In the energy markets, parties often enter into contracts where delivery is initially contemplated, but may ultimately be subject to a book-out or similar event. The occurrence of a failure to deliver may result in the recharacterization of a physical forward contract as a swap, subjecting it to regulation under the bill. The physical delivery exemption in the bill should be based on the traditional definition of forward contracts (i.e., contracts with the expectation of physical delivery).

A number of organized markets used in the delivery of electricity, such as regional transmission organizations and independent system operators, trade in physical products and closely related financial products. These markets are approved by and subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC) or, in the case of ERCOT, by the Public Utility Commission of Texas. These markets are directly related to the reliable delivery of electricity and have rules and standards governing participation, creditworthiness, market concentration and other matters. Under the language of the Proposal, these markets may be considered clearing organizations that are subject to

CFTC jurisdiction and some of their products, including financial transmission rights, could be considered "swaps." These markets should be specifically exempt from additional or duplicative regulation by the CFTC.

Conclusion

OTC commodity derivatives are fundamental risk management tools for domestic companies. This is a mature market consisting of diverse market participants and products with an established and stress-tested risk management infrastructure. The Proposal fails to consider these risk mitigating factors. A more refined approach that reflects the nuances of the commodity derivatives market and enables financial institutions to continue providing those businesses that depend on these risk mitigation tools access to such tools without adverse capital implications is needed. Forcing all or substantially all derivative instruments toward a one-size fits all model will only serve to eliminate the benefit of customization that creates benefit for the very consumers whose hedging needs are served by the derivatives markets.

Annex - Overview of the Proposal

The Administration's proposal (the "Proposal") seeks a "one-size-fits-all" regulatory treatment for all OTC derivatives, irrespective of the nature of different OTC derivative markets and market participants and the nature of the risks they incur (or don't incur).

The Proposal would restructure many aspects of how commodity market participants, including commercial producers hedging their price risks, would access OTC commodity derivatives. Among other things, the Proposal would:

- require all "standardized" commodity derivative contracts of a swaps dealer or a major swap participant ("regulated entities") be cleared through a registered clearing organization and traded on an exchange or a registered alternative swap execution facility ("ASEF") unless one counterparty to the trade is not a regulated entity⁴ and does not meet the eligibility requirements of a registered derivatives clearing organization or agency ("DCO");
- create a presumption that any commodity contract accepted by any DCO is standardized;
- require reporting of non-cleared trades by both counterparties to a swap trade repository or to the SEC and/or CFTC;
- impose capital requirements on all cleared and non-cleared commodity swaps with the requirements for non-cleared commodity swaps set at a higher level than those for cleared commodity swaps;
- impose margin requirements on all non-cleared commodity swaps with certain limited exceptions; and
- explicitly limit the exemptive authority of the SEC and CFTC over commodity swaps provisions to those areas in which the regulators are specifically authorized to grant exemptions.

⁴ For purposes of this note, the term swap dealer shall include security-based swap dealer and the term major swap participant shall include major security-based swap participant.