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Submitted Electronically

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Re: Comment to Notice of Proposed Rulemaking – Standardized Approach for Calculating the Exposure Amount of Derivative Contracts

Dear Ladies and Gentlemen:

The American Public Gas Association (“APGA”) appreciates the opportunity to provide comments in response to the Notice of Proposed Rulemaking regarding proposed revisions to the standardized approach for calculating the exposure amount (“SA-CCR”) of derivatives contracts of financial holding companies (the “Proposed Rule”). The Proposed Rule, issued jointly by the Office of the Comptroller of the Currency (the “OCC”), the Board of Governors of the Federal Reserve System (the “Board”), and the Federal Deposit Insurance Corporation (the “FDIC”, together with the OCC and the Board, the “Prudential Regulators”), threatens the ability of APGA’s members to continue to manage their natural gas price risk: it is likely to result in significant and unnecessary costs for end-user companies.

I. Introduction

APGA’s comments herein are addressed to regulatory disconnect between the existing end user exemptions for clearing and margins and this Proposed Rule. APGA’s interests concern routine efforts of its members to use swaps to reduce the volatility of natural gas prices paid by their consumers (commodity forward contracts for physical sales of natural gas), as well as the treatment of certain commodity swaps used to hedge municipal prepayment transactions for the supply of long-term natural gas.

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 25 years. 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. These swaps are vital to the ratepayers of municipally- and community-owned local distributors of natural gas.

Accordingly, following the Dodd-Frank Wall Street Reform and Consumer Protection Act, APGA worked with other end users of swaps to persuade regulators that certain proposed swap regulations would increase costs of natural gas price hedges and reduce competition by reducing the number of entities offering such services consumed by APGA members. APGA and others succeeded in obtaining two critical “end user exemptions.”

- In 2016, the CFTC finalized a rule: *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 6, 2016) (did not require swap dealers ("SDs") and major swap participants ("MSPs") to collect margin from non-financial end users).

These regulatory outcomes followed the reason that Congress chose to provide an “end-user exception” to mandatory clearing of swaps under Section 2(h)(7)(A) of the Commodity Exchange Act (“CEA”) and a “hedging affiliate” exception to clearing under Section 2(h)(7)(D) of the CEA under Dodd-Frank. Both of these exceptions are only available for swaps that are entered into to hedge or mitigate an entity’s exposure to commercial risk.

APGA certainly understands and supports the goal of ensuring reasonable credit safeguards in the derivatives arena. Nonetheless, we are concerned that the Proposed Rule effectively would eliminate the end user exemption established by Congress and then implemented by regulators. Absent those exemptions, swap transaction costs for end users would be higher, and there would be less market liquidity. The same is true of capital requirements, as APGA has long maintained.

While the Current Exposure Method used by banks to calculate counterparty credit risk exposure and risk-weighted assets ("RWA") may require updating, the proposal under SA-CCR to calculate counterparty credit risk exposures and RWA (especially in the commodities space familiar to APGA), if adopted as proposed, are potentially catastrophic for the natural gas industry. While we recognize that the Proposed Rule is a direct requirement on banks, the Proposed Rule would have indirect, adverse and material impacts on end-users, which routinely rely on derivatives executed with bank counterparties to...
hedge risk associated with their commercial operations. Similarly, the Proposed Rule would have the same impact on natural gas producers that require swaps to manage the supply side of the business. The result is likely to be an unnecessary increase in costs to natural gas consumers.

Therefore, APGA requests that the Prudential Regulators reconsider the proposed metrics under SA-CCR for calculating counterparty credit risk and RWA to ensure that the Proposed Rule does not undermine and frustrate the legislatively prescribed end-user benefits enjoyed by our members. In particular, we believe that any final rule regarding SA-CCR should provide a clear exemption for derivatives of a counterparty that:

(i) satisfies the criteria to qualify for an exception from clearing under section 2(h)(7)(A) of the Commodity Exchange Act (“CEA”) and implementing regulations;

(ii) satisfies the criteria in section 2(h)(7)(D) and implementing regulations;

(iii) qualifies for an exception from clearing under a rule, regulation, or order that the CFTC has issued pursuant to its authority under section 4(c)(1) of the CEA concerning cooperative entities that would otherwise be subject to the requirements of section 2(h)(1)(A) of the CEA;

(iv) is otherwise exempt from the clearing requirements of section 2(h)(1)(A) of the CEA; or

(v) is exempt from the initial and variation margin requirements imposed by rules adopted pursuant to sections 4s(e)(2)(A)(ii) and 4s(e)(B)(ii) of the CEA.

Further, as explained below, APGA respectfully requests that the Proposed Rule be modified to exempt transactions involving matched commodity swaps used in connection with Municipal Prepayment Transactions from any direct or indirect capital charge.

II. APGA

APGA is the national association of publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 37 states and approximately 730 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. Nearly all attempt to reduce their exposure to price volatility by hedging their purchases of natural gas for resell in some fashion, including both commodity forward contracts for physical sales of natural gas and execution of customizable over-the-counter (“OTC”) swaps. By and large, as local governmental entities, APGA members enjoy the highest credit ratings.

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 prepaid gas suppliers are required to post capital to cover the tenor of the “back-end” swap as if it were not a “tear-up” swap, it would be prohibitively expensive for them to enter into the swaps. Moreover, prepaid gas suppliers 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 Hedging Transactions for Natural Gas

A. The Price of Natural Gas Is Historically Volatile

Since the deregulation of the price of natural gas and the imposition of open access on interstate pipelines more than 25 years ago, natural gas has been one of the most price volatile commodities. The price remains subject to unpredictable weather events and seasonal pricing abnormalities. Accordingly, most local distributors of natural gas that purchase for ultimate consumers engage in some more of price risk mitigation. Such distributors execute hedging strategies at the behest of large industrial customers that require price stability for the manufacture of their product. For many APGA members, this entails direct OTC customizable hedges with a financial institution that are exempt from both clearing and margin requirements.

B. Municipal Commodity Forward Contracts For Physical Sales Of Natural Gas

Many if not most APGA members engage routinely in commodity forward contracts for physical sales of natural gas as a method to control price risk ultimately born by their consumers. When used in the Proposed Rule, the term “derivative contract” includes commodity swap transactions under the term “commodity derivative contracts” and appears to include commodity forward contracts for physical sales of commodities (see 12 Proposed Rule, CFR Section 217.2). If so, then the SA-CCR method of determining the “credit risk” that a counterparty may fail to make a payment under a “derivatives contract” will apply to physically-settled transactions for supplies of natural gas and other commodities between counterparties and certain banking organizations.

This is particularly alarming to APGA. Such an application to forward contracts is completely contrary to the CFTC’s determinations on clearing and margin. Congress granted the CFTC in Dodd-Frank jurisdiction to regulate commodity swap transactions, but left intact the CFTC’s exemption of physically-settled forward contracts from the CFTC’s swap transaction regulations. The Proposed Rule would turn upside down this status quo.

Moreover, the Proposed rule overlooks the credit risk reducing value of the various forms of credit support provided by counterparties in the form of bilaterally-negotiated credit support arrangements for unmargined derivatives contracts. Credit risk (seldom an issue for highly rated local governments) is reduced by counterparties providing credit support agreements, letters of credit, liens on physical assets, and other forms of bona fide credit support with respect to unmargined derivative contracts. The Proposed Rule further overlooks the fact that local governmental utilities using physically-settled commodity forward contracts are counting on these contracts for the purchase or sale of energy commodities necessary to their utility function. These utilities are less likely to default on payments under unmargined derivative contracts because such entities are prudently using these derivatives contracts to hedge their exposure to price risk for their customers. APGA would contend that this subset of counterparties is much more responsible than other participants in the US economy that choose to ignore commercial risk and not hedge or mitigate those risks. The Proposed Rule threatens to remove this necessary risk management tool altogether by reducing liquidity in that derivatives marketplace.

5 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.
C. Municipal Prepayment Transactions

Many APGA members participate in Municipal Prepayment Transactions. A long-term OTC commodity swap is the foundation of that transaction. 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.

Since their inception in the 1990s, Municipal Prepayment Transactions hedged with the 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. There is no question that Municipal Prepayment Transactions further important social and economic goals.

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.

1. 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 to 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.

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.

2. Matched Commodity Swaps Entered Into to Hedge Municipal Prepayment Transactions Should Not be Subject to Incremental Capital

The gas agency in a Municipal Prepayment Transaction is always a commercial end user. The prepaid gas supplier and the commodity swap counterparty, however, could be swap entities or other financial entities. 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. Under the Proposed Rule, capital reserve requirements threaten to increase the costs of these transactions substantially, making them economically unworkable. That would cause substantial harm to municipally owned natural gas systems and their ratepayers.

APGA therefore respectfully requests that the Commission modify its proposed capital rules to exempt transactions involving matched commodity swaps used in connection with Municipal Prepayment Transactions from any direct or indirect capital charge.

IV. 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. It is critical that APGA’s members be able to continue to hedge their commercial risks within this framework without incurring undue and unnecessary additional costs.
We ask that the Prudential Regulators do not cancel out the end user exemptions directed by Congress and the Commodity Futures Trading Commission. Similar exemptions for capital requirements should be made part of any final rule. Only in this way can APGA’s 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 me or David Schryver, Executive Vice President at 202-464-2742, or John P. Gregg, General Counsel, McCarter English, LLP, 202-753-3400.

Respectfully submitted,

Bert Kalisch,
President and CEO