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# Task force: Dodd-Frank could impede risk management, hedging

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The Dodd-Frank Wall Street Reform and Consumer Protection Act "has the potential to significantly alter the nature of — and cost of — price risk mitigation for gas buyers and sellers alike," according to a task force report released by the Bipartisan Policy Center and the American Clean Skies Foundation.

The Task Force on Ensuring Stable Natural Gas Markets said that while the U.S. Commodity Futures Trading Commission is yet to promulgate many of the details of the regulation, some particulars involve important exceptions for end users and bona fide hedges and the criteria used to establish "de minimis" participants.

"The challenge for the CFTC will be to craft rules that, on the one hand, protect the American public and the U.S. economy from destructive financial practices and techniques without, on the other hand, unduly restricting the use of bona fide hedging tools in natural gas and other energy commodity markets in ways that, by hindering the efficient management of risk, would cause producers and consumers to [forgo] large potential savings and discourage gas-related investments going forward," the task force said.

The task force recommended that the CFTC and other federal regulators use caution when adopting measures that would limit the scope of bona fide hedging opportunities in the natural gas market.

"Given the potential benefits associated with greater price stability, it is important that producers (and consumers) have an adequate range of affordable commercial hedging opportunities to bring this supply to the market at reasonable prices," the group concluded. "Regulations that unreasonably limit such arrangements would be counterproductive and could lead to more, not less, price stability."

Many industry insiders expect the end-user exemption to apply to a large number of risk management transactions that rely on derivatives for hedging purposes. However, parties will need to verify that individual transactions meet the eligibility criteria for this exemption, the report said. In addition, standardized energy futures contracts may come to face many additional regulatory requirements from which they are now exempt.

Under Title VII of Dodd-Frank, the CFTC can require that natural gas and other energy swap products be cleared by a centralized clearinghouse. The legislation could also impose additional marginal and collateral requirements, capital requirements, segregation of funds, and regulation of exchanges and swap execution facilities, or SEFs.

"In addition, many market participants will be subject to new standards of business conduct and reporting requirements that have yet to be promulgated by regulators," the task force noted. "These requirements are likely to create costs associated with compliance and record keeping as well as liabilities for the actions of individuals within organization."

Many economists, analysts and market players have expressed concerns regarding how the new rules will affect the administrative and economic costs of hedging, the number and type of derivative contracts that will be transacted in the markets, the liquidity of contracts that are available and the costs associated with transactions as manifested by larger bid-ask spreads, the potential for increased "unhedged" basis risk, increases in balance sheet risk for participating entities, and increased risk for market users and their customers.

"In addition, the legislation brings a new complexity to the regulatory landscape, creating the potential for overlapping jurisdiction and regulation for natural gas and energy market participants," the report said. "For example, transactions that involve 'basis risk' and physical gas could be subjected to regulation by CFTC, FERC or both, with different timelines for recordkeeping and reporting. In short, while the new regulations are still unclear, they risk limiting the ability of gas market participants to manage price risk through financial methods."

"In general, our concern is that new regulations could limit the availability and increase the cost of tools that are used by market participants to manage price risk and achieve greater price stability," the group said.

Higher costs could affect even transactions that are exempt from the new regulations as even the exempt transactions are likely to face increased costs and reduced availability and liquidity due to the capital that will be reserved and the margin that will have to be posted by financial institutions, swap dealers and major swap participants who may be counterparties.