

HEDGING THE DODD-FRANK ACT

Here's how the new financial legislation will affect the financial products that are energy companies' lifeblood: commodities hedging and debt financing.

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The Dodd-Frank Wall Street Reform Act is the most significant financial legislation enacted since the Depression-era reforms of 75 years ago. Its 2,300 pages govern nearly every area of our financial lives. It is complicated and open-ended: In writing regulations, government agencies will decide the winners and losers. Everyone agrees the legislation will be a game-changer.

Dodd-Frank targets banks but also regulates any company using certain financial products. For energy companies, there will be effects on the financial products that are their lifeblood: commodities hedges and debt financing.

Managing energy risk

Oil, natural gas and electric-power companies cannot raise and invest capital if commodity-price risk is too great. They must know that commodity prices will create enough revenue to at least cover their costs. If prices are too low, revenue does not cover costs, profit disappears and the entire enterprise is at risk.

Energy companies can sell a certain amount of their products forward. These physical hedges mean that companies must find buyers to take the right amounts of product at the right times and places, and commit to doing so for the right length of time. Alternatively, they can find an investor who will provide the financial equivalent. Since the need to hedge is financial in nature, these financial



hedges provide price stability and a superior solution to commodity-price risk.

In the financial markets, energy companies can find a more liquid market of counterparties and a less expensive way to guarantee commodity prices. Physical or financial hedges with an energy company are a way to extend credit to that company; depending on price changes, the company could owe or be “out of the money.” Counterparties must evaluate the company’s credit, and may require collateral or margin to be set aside to assure payment.

Since December 2000, energy hedges (financial and physical) have been largely exempt from regulation under the Commodity Exchange Act. Dodd-Frank increases regulation of financial energy hedges, while physical hedges remain largely unregulated.

The most common way that oil, gas and electric-power companies manage price risk is by entering into financial hedges directly with a counterparty. Energy companies prefer over-the-counter (OTC) hedges, because the hedges and their credit terms are custom made, like a tailored suit. Clearinghouses provide energy companies with another option: off-the-rack hedges that do not fit as well, because they adopt a one-size-fits-all approach to margin requirements. This is akin to requiring that you wear a thick wool suit whether you live in Houston or Chicago.

Dodd-Frank effects

When the Dodd-Frank laws and regulations are implemented, energy companies will need to determine if they are commer-

cial end users. If they are not, entering into financial hedges will subject them to regulations, including the need to post margin, designed for financial institutions or large trading companies. Even if they are commercial end users, Dodd-Frank still may limit hedging.

How do you know if you are a commercial end user? To be sure, you will have to study the law and regulations promulgated by the Commodity Futures Trading Commission (CFTC) over the next year.

But here is an early test: Dodd-Frank’s Section 761 prescribes three principal measurements to determine whether an energy company is a commercial end user.

- Is one of the parties not a “financial entity”?
- Is the energy company entering into the swap to “hedge or mitigate commercial risk”?
- Did the energy company “notify” the CFTC “in a manner set forth by” the CFTC that it will “generally meet its financial obligations associated with entering into non-cleared swaps”?

If a transaction doesn’t meet all three, then the energy company must clear hedges and post margin through a clearinghouse.

Let’s take a closer look.

Non-Financial Entity. Normally this will not be a concern for energy companies who do not have large, active energy-trading departments.

Hedging Or Mitigating Commercial Risk. To determine if a new hedge qualifies, it matters how you are currently using hedges. This could mean having to explain to the CFTC how all of your hedges work for each new hedge. But until the regulations are known, we can only speculate on how the CFTC will implement this requirement.

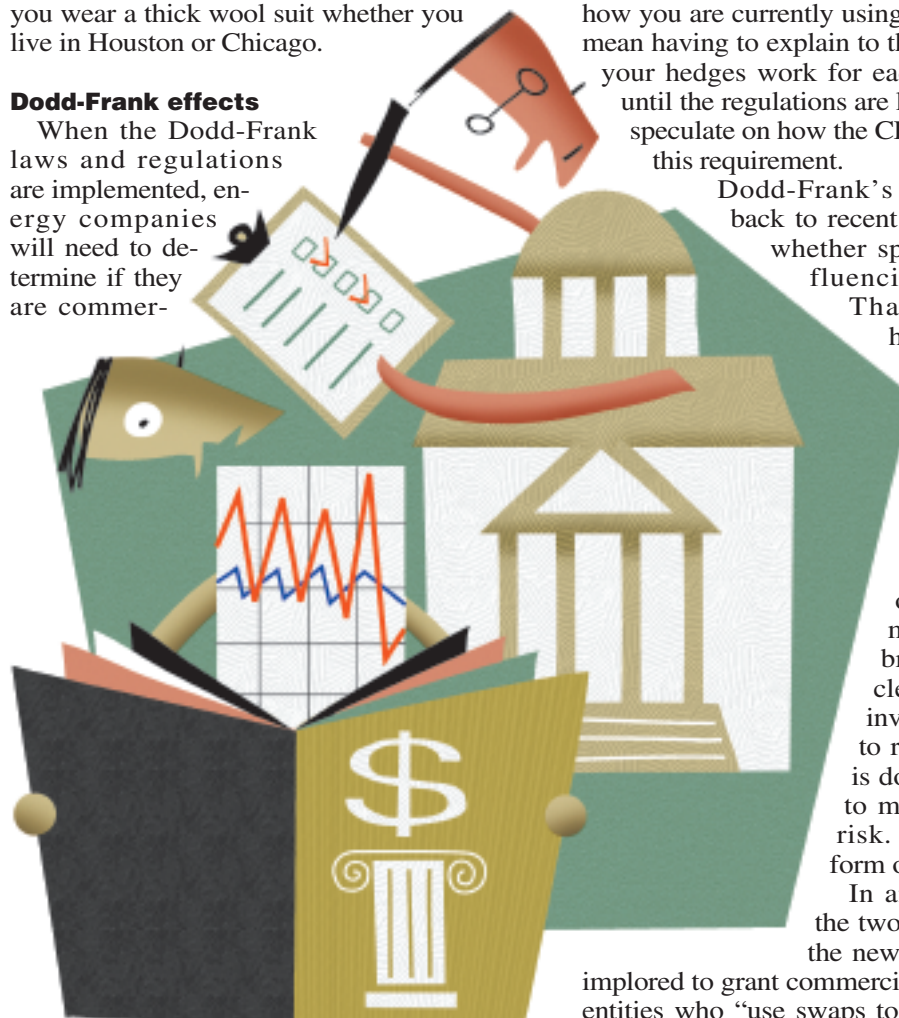
Dodd-Frank’s language harkens back to recent public debate over whether speculators were influencing energy prices.

That debate showed how difficult it was to sort out legitimate motives.

Certainly, creating a fraud or otherwise manipulating the market would not fit under the “hedge or mitigate commercial risk” umbrella. But it is less clear whether a fund investing in oil hedges to reduce inflation risk is doing so to hedge, or to mitigate commercial risk. Is inflation risk a form of commercial risk?

In an open letter from the two Senate sponsors of the new law, regulators are implored to grant commercial end-user status to entities who “use swaps to hedge risk in their

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ordinary course of business” and who manage risk “appropriately.” What is appropriate seems subjective. Commodity derivatives currently have a notional value of \$2.9 trillion, and much of that is in energy commodities. Will the CFTC really decide which are “appropriate” for commercial end-user status?

There are so many permutations of these financial arrangements that if the CFTC draws clear lines, then one could imagine that no matter how extensive the regulations are, there will be situations that fall into the cracks—either accidentally or by design. If the CFTC takes a more subjective “I know it when I see it” approach, then companies must be prepared to spend substantial time being measured up by the CFTC to determine whether they can enter over-the-counter hedges without regulation.

More questions than answers

Some of the process and structuring questions include: Will measurements be taken before each hedge? Will there be a continual reporting requirement? Will sales of assets trigger another examination by the CFTC and require the sell-off of hedges? Will a drop in oil and gas production or electric generation require another examination and the sell-off of hedges? What if the drop in production is from a drilling moratorium?

Can a company sell production or generation to one entity and the hedges to another (which could allow for the same production or generation to justify multiple sets of hedges)? Can a company close out a hedge, lock in a profit and sell a pair of hedges to monetize the profit, thus separating the hedges from the production or generation? What if the company does it regularly?

Can a company use gas to hedge electricity? Can a company use weather derivatives to hedge gas or electricity (cross-product hedges)? Can a company hedge electricity in one market against electricity or gas in another market? Can a company mix physical and financial hedges to prove they are for risk mitigation?

Meeting Financial Obligations. The third measurement in determining whether an energy company achieves commercial end-user status is whether it can “generally meet its financial obligations associated with entering into non-cleared swaps,” according to Dodd-Frank’s Section 761. This last requirement has generated much discussion. In earlier drafts of financial-overhaul legislation there was an express statement that certain swap counterparties would not be required to put up collateral. In the final version of the commercial end-user exception, this statement was absent, causing speculation that commercial end users may be required to separately collateralize their hedges.

Dodd-Frank, taken literally, would grant the CFTC broad authority to decide whether and how much collateral energy companies would have to post if forced into clearinghouses. But

in the weeks leading up to passage of the law, business leaders expressed concern that collateral requirements would hurt businesses by causing them to choose between using collateral for borrowing money or for hedges. This would have the perverse result of businesses reducing hedges and increasing risks. According to the *Wall Street Journal*, this concern amounted to a “fury among bankers and business groups” over the language in the financial overhaul bill. To allay this concern, on June 30, Chris Dodd, D-Conn., and Blanche Lincoln, D-Ark., Senate sponsors of the legislation, sent an open letter to House leaders.

The letter states, “The legislation does not authorize the regulators to impose margin on end users.” It goes on to say, “It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth.” In this way, the sponsors acknowledge the burden imposed by increased margin requirements. The CFTC is tasked with threading the regulatory needle and weaving together these conflicting goals of improving credit without raising margin requirements.

The legislation and the letter may be at odds. How can the regulators increase the certainty that commercial end users meet their “financial obligations associated with entering into non-cleared swaps” without increasing margin requirements? The Dodd-Lincoln letter tries to find a gap between a rock and a hard place by stating that “margin on the dealer side of the transaction should reflect the counterparty risk of the transaction and Congress strongly encourages regulators to establish margin requirements for such swaps or security-based swaps in a manner that is consistent with the congressional intent to protect end users from burdensome costs.” Apparently, the intent of sponsors Dodd and Lincoln is that the commercial end user would not be required to post margin but its counterparty would.

If Dodd-Frank requires margin to be posted by the counterparty, the counterparty can require the commercial end user to match it dollar for dollar. That means less collateral for borrowing money, and perhaps a de-leveraging of the energy industry.

Less capital for the energy industry would create financial stress for the most leveraged companies, and generally would result in decreased investment. Regulations will assume an important role, with profound influence on the flow of credit. This fall and winter, these very important issues will be addressed in the form of regulations to be promulgated by the CFTC. Energy companies should stay tuned. □

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