TESTIMONY OF JEFF BILLINGS

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THE AMERICAN PUBLIC GAS ASSOCIATION

BEFORE THE HOUSE AGRICULTURE COMMITTEE

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Chairman Lincoln, Ranking Member Chambliss and Members of the Committee, I appreciate this opportunity to testify before you today and I thank the Committee for calling this hearing on reform of the over-the-counter derivatives market. My name is Jeff Billings and I am the Manager of Risk Management for the Municipal Gas Authority of Georgia. The Municipal Gas Authority of Georgia is the largest non-profit natural gas joint action agency in the United States. We have 76 public gas system members in five states: Georgia; Alabama; Florida; Pennsylvania; and Tennessee. Together, these systems meet the gas needs of approximately 243,000 customers.

I testify today on behalf of the American Public Gas Association (APGA). APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and over 720 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.

APGA's number one priority is the safe and reliable delivery of affordable natural gas. If we are to fully utilize clean domestically produced natural gas at long-term affordable prices, we ultimately need to increase the supply of natural gas. However, equally critical is to restore public confidence in the pricing of natural gas. This requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation, abusive market conduct or excessive speculation.

Over the past several years, and leading up to the passage of the CFTC Reauthorization Act, APGA has sounded the alarm with respect to the need for greater oversight and transparency of the over-the-counter markets ("OTC") in financial contracts for natural gas. APGA previously testified before the House, Senate and Commodity Futures Trading Commission (CFTC) that APGA's members had lost confidence that the prices for natural gas in the futures and the economically linked OTC markets are an accurate reflection of supply and demand conditions for natural gas. APGA further testified that restoring trust in the validity of the pricing in these markets requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation, excessive speculation or other abusive market conduct. APGA therefore strongly supported an increase in the level of transparency with respect to trading activity

in these markets. For this reason, APGA strongly supported the recent enactment of the CFTC Reauthorization Act of 2008 .[1]

The Reauthorization Act

APGA believes that the increased regulatory, reporting and self-regulatory provisions relating to the unregulated energy trading platforms contained in the CFTC Reauthorization Act of 2008 was, and is, a critically important step in addressing our concerns. We commend this Committee for its work on the Reauthorization Act. The market transparency language that was included in the Reauthorization Act will help shed light on whether market prices in significant price discovery energy contracts are responding to legitimate forces of supply and demand or to other, non-bona fide market forces.

APGA also notes that the CFTC, under the leadership of Chairman Gensler, has taken many significant steps to address the concerns raised by APGA, exercising the new authority provided under the Reauthorization Act and its existing administrative authority under the Act. For example, the CFTC has exercised the authority given it in the Reauthorization Act, finding that the LD1 natural gas contract traded on the Intercontinental Exchange, Inc. is a significant price discovery contract[2] and is thereby

[1] Food, Conservation, and Energy Act of 2008, PL 110-246, 122 Stat. 2189, Title XIII.
[2] See "Order Finding That the ICE Henry Financial LD1 Fixed Price Contract Traded on the Intercontinental Exchange, Inc., Performs a Significant Price Discovery Function," 74 *Fed. Reg.* 37988 (July 30, 2009) . Since July, the CFTC has issued a number of orders finding additional contracts to be significant pirce discovery contracts..

subject to the enhanced regulatory requirements of the Reauthorization Act. It also is providing enhanced transparency through its Commitment of Traders Report and is using its special call reporting authority aggressively in connection with OTC contracts. In addition, the CFTC has formed and continues to seek advice of an energy markets advisory committee. Many of these steps were first recommended by APGA. APGA believes that all of these enhancements have been important steps in addressing the problems faced by the markets in natural gas.

Need for Additional Legislation

As APGA has stated in prior testimony, we believe that it is necessary for Congress to provide the CFTC with additional statutory authorities and adequate resources to respond fully and effectively to the issues raised by trading in the energy markets. Specifically, additional transparency measures with respect to transactions in the OTC markets are needed to enable the cop on the beat to assemble a full picture of a trader's position and thereby understand a large trader's potential impact on the market.

APGA is supportive of the approach taken in H.R. 3795, The Derivative Markets Transparency and Accountability Act of 2009, recently reported by the House Agriculture Committee. We believe this legislation offers Congress a constructive basis for addressing many of the issues that remain open following enactment of the Reauthorization Act. Specifically, APGA is strongly supportive of provisions in the legislation requiring reporting by large traders of OTC positions and the application of aggregate speculative position

limits. APGA believes that these regulatory tools to enhance transparency, and to limit excessively large speculative positions, are a critically important step in effectively and fully addressing the issue we have raised with respect to pricing anomalies in the natural gas market and complete the work begun in the Reauthorization.

Mandatory Clearing.

APGA also strongly supports the statutory exemption in H.R. 3795 for end-users from the mandated clearing of OTC contracts. There are currently several proposals under consideration in Congress that differ from H.R. 3795 in that they would mandate the clearing of all standardized OTC transactions regardless of the nature of the customer. Mandated clearing would have a significant impact upon public gas systems and their customers. Specifically, requiring public gas systems to clear their OTC transactions would increase their cost of hedging and as a result, subject their natural gas customers to higher prices for natural gas. Or, the increased cost of hedging may result in natural gas systems reducing their hedging transactions, subjecting their customers to greater price volatility and again, increasing the cost of natural gas to their customers.

Public gas systems depend upon both the physical commodity markets as well as the markets in OTC derivatives to meet the natural gas needs of their consumers. Together, these markets play a critical role in these utilities securing natural gas supplies at stable prices for their communities. Specifically, natural gas distributors purchase firm

supplies in the physical delivery market at prevailing market prices, and enter into OTC derivative agreements customized to meet their specific needs, reduce their consumers' exposure to future market price fluctuations and stabilize rates. By using both markets, these public gas systems are able to purchase firm deliveries of natural gas from a diverse set of suppliers while hedging the risk of future market price fluctuations.

However, proposals that would require all standardized OTC derivatives transactions to be cleared would significantly impair the financial ability of public gas systems to engage in these gas supply strategies. Under current practices in the OTC markets, many public gas systems based upon their very-high credit worthiness are not required to post collateral as long as a gas system's exposure stays below a predetermined threshold. Moreover, adjustments to collateral levels are made on a pre-defined, periodic basis. This is particularly suitable to the routine funding and fee collection practices of public natural gas distribution systems. In contrast, the mandated clearing of all OTC transactions would require public gas systems to post initial margin for all transactions and to hold money in accounts to meet potential margin calls whenever required on little notice. This would constitute a significant financial and operational burden on these systems, their communities and their consumers. Moreover, the proposed mandate to clear all standardized OTC derivatives transactions would increase costs for public gas systems and their municipalities; an increase which would be borne 100% by their consumers.

By way of example, in the case of the Municipal Gas Authority of Georgia, we have determined that based on our current hedge positions, mandatory clearing would require us to post initial margins in the range of $163 million to $243 million. The following table shows how we developed this calculation:

Type of Hedging	Volumes Currently Hedged (MMBtu)	Contract Equivalent (Contract = 10,000 MMBtu)	Initial Margin Requirement at $5,000/Contract	Initial Margin Requirement at $7,500/Contract
Residential, Commercial & Industrial Load	38,883,000	3,888	$ 19,440,000	$ 29,160,000
Storage Gas	6,140,000	614	3,070,000	4,605,000
Long-Term Supplies*	278,374,000	27,837	139,187,000	208,780,000
Basis Swaps**	27,410,000	10,964	2,741,000	2,741,000
Total	350,807,000	43,303	$ 164,438,000	$ 245,286,000

* Long-term supplies include hedges associated with 15 and 20 year firm supply prepayments and acquisitions of natural gas reserves.

** Basis swaps assume a contract equivalent of 2,500 MMBtu per contract.

You will see in the above table that two different estimates for the initial capital requirement were considered-- $5,000 per contract and $7,500 per contract. The initial capital requirement for a NYMEX contract (10,000 MMBtu) is currently $4,000 per contract. However, NYMEX adjusts this capital requirement based on the overall price of natural gas and volatility. When natural gas prices hit their peak last year, the initial capital requirement was over $10,000.

In addition to the initial capital requirement, the clearing exchanges can and do require additional capital contributions based on daily mark-to-market calculations which account for fluctuations in the price of natural gas. For this reason, we would have to obtain a line of credit substantially larger than the initial capital requirement range of $163 million to $243 million to be prepared to cover capital calls resulting from a change in natural gas prices. Assuming an overall line of $500 million for our hedging activity with $200 million funded for the initial capital requirement, the added borrowing costs for our organization could easily exceed $10 million per year (based on the average interest rates of the past 5 years).

When spread over our members annual volumes, this added borrowing costs amounts to approximately 25 cents on every MMBtu delivered. This cost increase is the equivalent of doubling the cost of interstate pipeline transportation per MMBtu or raising distribution rates over 10 percent. As has been discussed previously in our testimony, this substantial increase in cost to the consumer comes without any benefit.

It has been suggested that the clearing requirements would be less burdensome if some end-users are given the option of posting non-cash collateral. Unfortunately, the alternative of using non-cash collateral would not provide any relief to public gas systems. Public gas systems generally are prohibited by their constitutional documents from pledging as collateral the components of their physical infrastructure, such as pipelines. Accordingly, public gas systems would only be permitted to pledge non-cash

collateral in the form of liquid assets. However, public gas systems simply do not maintain such liquid assets in the quantity necessary to meet the requirements associated with clearing. And maintaining this level of liquid assets would be at odds with their routine funding operations.

Another result of mandatory clearing would be the de facto elimination of the use of tax-exempt financing for the prepayment of long-term natural gas contracts, also known as "prepays." Prepays were endorsed by Congress as part of the Energy Policy Act of 2005 and have been a key tool that public gas systems, including the Municipal Gas Authority of Georgia, have used to secure long-term, firm supplies for terms up to 30 years. One critical component of the prepay is an OTC swap transaction that enables the public gas system to ultimately pay a price discounted below the prevailing spot market price. Importantly, the OTC derivatives utilized in prepays are "tear up" agreements, that is, they terminate at no cost in the event the prepay terminates. Because of their size and long-range nature, requiring clearing of the prepay swap would be cost prohibitive, thereby eliminating a tool public gas systems have utilized to lock into long-term supplies of natural gas and protect our consumers from price volatility.

Accordingly, APGA strongly rejects the suggestion that all OTC derivatives be required to be cleared regardless of the nature of the end-user counterparty. That suggestion, if enacted into law, would constitute a significant financial and operational burden on publicly owned natural gas distribution systems, their communities and their consumers, and would not address the systemic risk problems which have brought about

the current financial crises. From our perspective, the continued availability of individually negotiated, non-cleared OTC transactions will provide public gas systems with the widest range of tools to continue to offer natural gas at the best possible prices to their customers. The customers of public gas systems reap the benefits of these arrangements through lower rates for the natural gas which they purchase. The hedging of natural gas supply purchases by public gas systems using non-cleared bi-lateral OTC derivatives do not present the types of systemic risks posed by some dealers of credit-default swaps, which is the impetus behind the proposed clearing mandate. For this reason, APGA supports the approach of the House Agriculture Committee in requiring those exempted end-users to demonstrate to the CFTC that their transactions are for legitimate hedging purposes.

Accordingly, as Congress considers reform of the OTC derivatives markets APGA strongly supports the inclusion of a statutory exemption from mandatory clearing for hedgers that are not major swap participants. To do otherwise, and to require non-systemically important end-users that enter into OTC transactions for hedging purposes to clear their OTC transactions is in essence punishing the victims of the recent financial crisis.

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Natural gas is a lifeblood of our economy and millions of consumers depend on natural gas every day to meet their daily needs. It is critical that the price those consumers are paying for natural gas comes about through the operation of fair and orderly markets and through appropriate market mechanisms that establish a fair and transparent marketplace. However, it is equally important that efforts to reform financial markets allow end-users, such as public gas systems, to continue to use the over-the-counter markets without incurring additional costs to hedge risk. APGA looks forward to working with the Committee to accomplish that goal.