Testimony

Before the
United States Senate
Committee on Agriculture, Nutrition & Forestry

On

Reforming U.S. Financial Market Regulations

Mark K. Boling
Executive Vice President and General Counsel
Southwestern Energy Company

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Good morning Madam Chairwoman and members of the Committee. My name is Mark Boling and I am Executive Vice President and General Counsel for Southwestern Energy Company, an independent energy company that is primarily engaged in natural gas exploration and production within the United States.

I appreciate the opportunity to appear before you today and provide testimony regarding the very important legislative effort to reform the over-the-counter (OTC) derivatives market.

One of the biggest challenges in enacting legislative reforms for the OTC derivatives market is that the term "over-the-counter market" covers a vast array of products across a number of markets, thereby making it extremely difficult to implement an effective "one size fits all" legislative solution. In this regard, it is important to note that energy derivatives did not cause the financial crisis of 2008 – credit default swaps and subprime mortgages did. It is also important to note that while we have witnessed the greatest economic crisis in 80 years, and perhaps the most volatile commodity market Southwestern has ever experienced, OTC derivatives in the energy markets performed well, did not create systemic risks, and in fact helped many end-users manage and hedge their risks during this very difficult time of extreme volatility. We support all legislative efforts to improve the transparency and stability of the OTC derivatives market and to ensure market integrity by preventing excessive speculation, manipulation and other abusive practices. However, we believe that any such legislation must recognize the significant differences between the various derivative markets and make a clear distinction between those market participants that engage in hedging transactions with the goal of managing the price risk inherent in their business and those market participants that engage in speculative transactions with the goal of achieving profits through the successful anticipation of price movements.

My testimony today will focus on four things:

- Why OTC swaps are so important to independent energy producers like Southwestern;
- The impact on Southwestern and other independent energy producers if they are required to clear or post cash margin for their hedging transactions;

- Southwestern's recommendation for the treatment of hedging transactions; and
- Southwestern's support of market transparency and reporting.

Why OTC swaps are so important to independent energy producers.

Southwestern Energy Company (NYSE: SWN) is a growing independent energy company. Since 2005, Southwestern has invested over $6.5 billion in its operations, all of which are located in the United States. These investments have resulted in substantial domestic job creation, increased direct and indirect business expansion, and significant federal, state and local tax revenues. Within our company alone, we have increased our employee base from 248 employees at year-end 2004 to approximately 1,500 employees today, an increase of over 600%.

Our ability to make over $6.5 billion of capital investments and create thousands of job opportunities during this period was primarily due to our ability to generate a reliable cash flow from the sale of our natural gas production and to gain access to additional funds borrowed under our bank revolving credit facility. The ability to generate a reliable stream of cash flow was due in large part to our use of OTC derivatives to "lock in" natural gas prices. Southwestern uses these derivatives as a risk management tool for our natural gas, a commodity that we produce, own, possess and market – we do not use derivatives for speculative purposes.[1]

The impact on Southwestern and other independent energy producers if they are required to clear or post cash margin for their hedging transactions.

Southwestern regularly hedges its natural gas price exposure by entering into OTC swap transactions with multiple counterparties with S&P credit ratings ranging from BBB+ to AA. Southwestern has typically hedged 60-80% of its expected natural gas production volumes for the following year. Southwestern does not post collateral with any swap counterparty -- for a very good reason: natural gas swaps ***lower*** Southwestern's business risk and makes it a much more stable company. Like all commodity producers, Southwestern is naturally "long" the commodity, and hence, naturally subjected to the risk of falling commodity prices. Southwestern's swap counterparties understand that Southwestern is reducing its business risks

[1] Attached to this testimony as Appendix 1 is a more detailed description of the types of OTC hedging instruments Southwestern utilizes to manage its natural gas price risk.

when transacting OTC swaps and, therefore, the credit risk to the swap dealer is greatly diminished thereby eliminating the need for Southwestern to post collateral.

The imposition of mandatory clearing and mandatory margining of our hedges would cause a significant drain on working capital at a time when capital is highly constrained and credit is in short supply. There will be a liquidity drain on those companies that have taken a conservative business approach by choosing to prudently hedge their economic risks. Mandatory margining will have the unintended consequence of actually increasing financial risks as companies choose not to hedge due to working capital constraints.

In addition, increasing hedging costs by forcing all standardized derivative trades onto a clearinghouse will result in fewer market participants, more price volatility, and less price discovery. Because of the increased costs, fewer market participants will be able to hedge or the ones that can hedge, will hedge a lower volume. With fewer transactions and fewer participants in the marketplace, there will be more price volatility and less price discovery. By driving out the bona fide hedgers, the market share of speculators will increase, which does not create a healthy functioning market. A healthy market requires a balance between bona fide hedgers and speculators.

Finally, if independent energy producers are forced to post cash collateral for natural gas hedging activities, they will be unable to fully invest in their business, the exploration and production of natural gas. The additional cost from posting cash collateral would be substantial and necessarily require that independent energy producers reduce their capital investments, resulting in a dramatic reduction in drilling activity, fewer jobs and a significant decrease in domestic natural gas production. After analyzing the potential costs of posting cash collateral, Southwestern determined that during 2009, without hedging, Southwestern would have drilled 240 fewer wells in its Fayetteville Shale Project resulting in the loss of 1,500 jobs and a total economic impact to the state of Arkansas of $1.6 billion. (Appendix 2) In addition, fewer wells drilled in the United States means less domestic gas is produced, and less gas produced unfortunately means higher prices for consumers. There is a real world effect to a mandatory clearing requirement for all standardized OTC derivatives.

<u>Southwestern's recommendation for the treatment of bona fide hedging transactions</u>.

Southwestern believes a solution to these problems would be to provide an exemption from the clearing and margining requirements for bona fide hedging transactions, where at least one party involved is a company that produces, owns and sells (or purchases and consumes) the commodity and the transaction is directly related to managing commodity pricing risks inherent to that company's operating activities. We believe these transactions are easily distinguishable from those that are purely speculative, which appears to be the primary focus of the proposed derivatives legislation. The purpose of a clearinghouse is to require participants with true "open" commodity price risk exposure (i.e. speculators) to post capital against such risk. A company that produces, owns and markets the commodity that is the subject of the derivative contract is inherently "long" in commodity price exposure, and when that company enters into a bona fide hedging transaction it "closes" that commodity price risk position, thereby making it more stable, not less. Adding a clearing requirement to hedging transactions would add no additional value to market stability.

<u>Southwestern's support of market transparency and reporting</u>.

While Southwestern already reports its hedging activities on an aggregated basis in its financial reports to the SEC, we support legislative proposals to further increase market transparency and reporting. We believe that reform of the OTC derivatives markets should increase transparency and oversight to provide confidence to both market participants and consumers in the fairness of these markets. Southwestern supports requirements for its hedging transactions to be reported on an aggregated and confidential basis to all appropriate regulatory agencies, including the SEC and the CFTC.

<u>Concluding Remarks</u>.

In conclusion, a clearing requirement for OTC derivatives, when applied appropriately, can play an important role in mitigating operational and counterparty risk for large segments of the OTC derivatives markets. However, we believe the broad application of a clearing requirement for all OTC derivatives will hurt many American companies, particularly in the energy sector, by effectively taking away the most powerful tool for managing price-related risk.

It is our hope that the concerns we have raised are addressed so that any proposed legislation does not significantly impair our ability to use derivatives to prudently hedge the risks we face in our day-to-day operations or to ensure our continued access to the credit sources we rely upon to grow our business. Ultimately, what matters most is that American companies continue to be allowed to cost-effectively manage risks in a manner that enhances market stability and contributes to both the overall health of the economy and our country's goal of achieving energy independence.

Madam Chairwoman and members of the Committee, this concludes my testimony. I would be happy to answer any questions you may have.

APPENDIX 1

Sample Derivative Instruments For
Hedging Natural Gas Price Risk

Southwestern hedges its natural gas price risk using OTC NYMEX gas swaps and costless collars. Both of these hedging instruments are simple and result in no initial net investment payment, thus preserving our cash flows for drilling and producing natural gas.

An OTC NYMEX swap hedge consists of a bilateral financial agreement between Southwestern and an OTC counterparty, in which Southwestern agrees to receive a fixed price for a specified volume of natural gas over a specified period of time. In return, Southwestern agrees to pay the OTC counterparty a floating price, based on a NYMEX Henry Hub monthly futures contract settlement price, for the same specified volume of natural gas over the same specified period of time. The bilateral agreement does not call for the physical exchange of natural gas; it is purely financial in nature. Upon monthly settlement, if the fixed price agreed upon in the original agreement is higher than the monthly settlement price of the NYMEX Henry Hub monthly futures contract, the OTC counterparty pays Southwestern the monetary amount of the difference in price multiplied by the specified volume. The reverse transaction takes place if the fixed price is lower than the monthly settlement price of the NYMEX futures contract. **Figure 1** below illustrates an example of an OTC NYMEX swap hedge transaction.

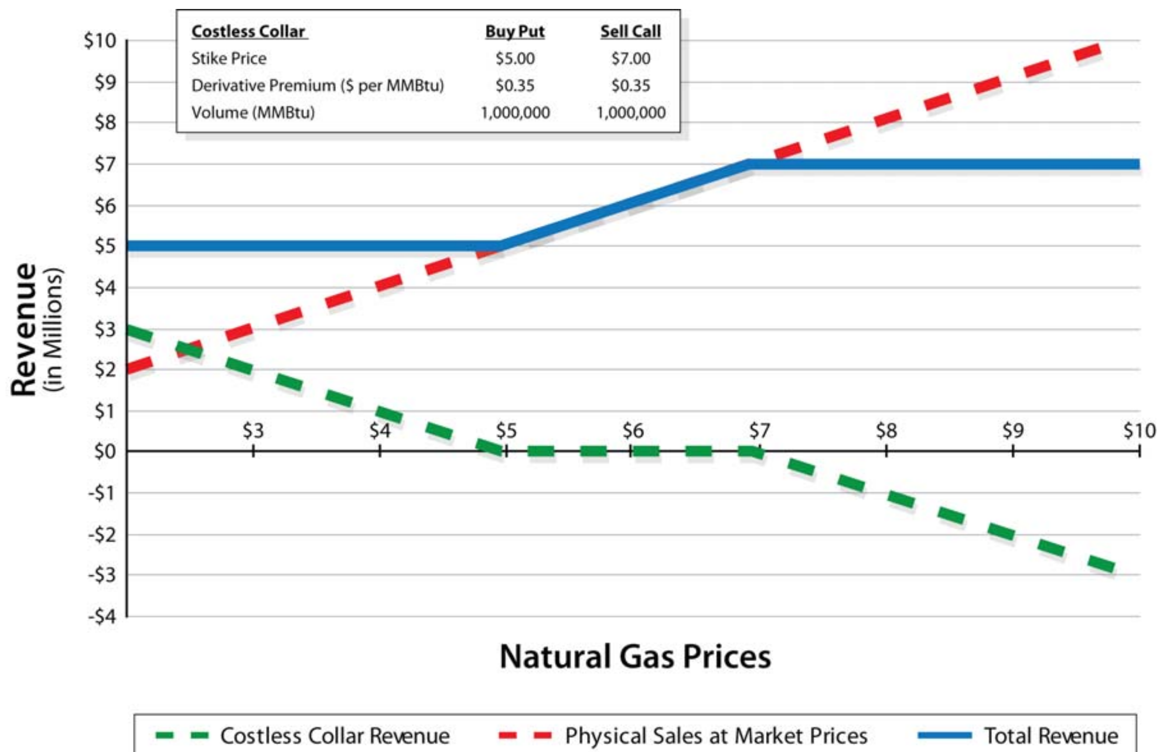
Figure 1

It is important to note that the financial settlement of the OTC hedge occurs at approximately the same time as the physical sale of the gas, thus eliminating a timing shortfall/surplus of cash for Southwestern. The hedge not only offsets the price risk but it also matches the timing of the cash flows so as to avoid funding risk for Southwestern.

Southwestern also hedges its natural gas price risk with another OTC hedge instrument widely used in the industry, the costless collar. The objective of using costless collars is to create a range of prices that Southwestern is willing to receive for its natural gas production. Costless collars use OTC derivatives, puts and calls, to create a floor price and ceiling price for a specified volume of gas over a specified period of time. Southwestern agrees to buy a put (the right to sell) at a specific strike price and, incorporated in the same transaction, also agrees to sell a call (the right to buy) at a higher specified strike price. Both the put and the call transactions

represent the same volume of natural gas for the same specified period of time. The put and call premiums (the prices for the derivatives) are the same, thus offsetting exactly for no initial net investment, hence the appropriate title for the instrument, the "costless" collar. Like the swap discussed above, the OTC counterparty takes the other side in the transaction. **Figure 2** below represents the revenue that would be generated by using a costless collar. The combination of physical sales at market prices and the costless collar revenue creates a range of possible revenues acceptable to Southwestern. This range of revenues creates stability that enables Southwestern to better budget its capital investments and develop its assets.

Figure 2



Southwestern's OTC counterparties have recognized the quality of the Company's producing assets and understand the concept of "right-way" risk, enabling Southwestern to hedge without having to post cash collateral. By hedging our natural gas production, Southwestern is guaranteed a future price and revenue stream. If actual prices end up being higher than our hedged price, Southwestern will owe money on the financial OTC hedge but will be actually selling the physical natural gas at higher prices enabling us to fulfill our contractual obligation on the financial OTC hedge. The reverse is also true, if prices are lower than the hedged price, the cash flow generated from the financial OTC hedge offsets the lower revenue from selling the physical natural gas at lower prices. The financial OTC hedge creates an extremely effective "offset" to Southwestern's actual physical sale of natural gas. It is Southwestern's contention and the contention of our OTC counterparties that "right-way" risk, along with our overall financial strength, afford us the ability to hedge without the need for posting cash collateral.