# WRITTEN STATEMENT

**OF**

**JAMES C. ALLISON**

**GAS & POWER RISK MANAGER, NORTH AMERICA**
**CONOCOPHILLIPS COMPANY**

**ON BEHALF OF THE WORKING GROUP OF**
**COMMERCIAL ENERGY FIRMS**

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**FOR THE HEARING:**

**"DEFINING THE MARKET: ENTITY AND PRODUCT CLASSIFICATIONS UNDER TITLE VII OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT"**

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**BEFORE THE**

**COMMITTEE ON AGRICULTURE**
**U.S. HOUSE OF REPRESENTATIVES**

***MARCH 31, 2011***

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## I. INTRODUCTION.

Chairman Lucas, Ranking Member Peterson, and members of the Committee; thank you for this opportunity to discuss certain key issues regarding the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the regulation of commodity derivatives, including the regulation of entities and products in commodity derivatives markets.

I am Jim Allison, North America Gas & Power Risk Manager for ConocoPhillips Company, and I am appearing today on behalf of the Working Group of Commercial Energy Firms. The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of energy commodities to others, including industrial, commercial, and residential consumers. My testimony and statements made today reflect the positions of the Working Group, and do not necessarily reflect the positions of ConocoPhillips or any individual member of the Working Group.

The Working Group supports the policy goals of the Dodd-Frank Act to promote the financial stability of the United States by improving accountability and transparency in the financial system and to reduce systemic risk. However, achieving these goals without imposing excessive costs and burdens on the economy is contingent on successful implementation of a

regulatory framework that accommodates the differences among the new entities, products, and markets that the CFTC will regulate under Title VII. Implementation of such regulations will be successful only if those regulations do not result in costs that are greater than the public benefit of the Dodd-Frank Act, and if those regulations are developed in a logical and prudent manner.

Among the Working Group's specific concerns with the CFTC's proposed rules regarding regulation of commodity derivatives markets are (1) the vagueness and potential breadth of the definitions of "swap dealer," "major swap participant," and "swap," and (2) the challenges posed by the CFTC's ongoing rulemaking process, including the sequencing of the issuance of proposed rules, the interdependent nature of many of those rules, and the limited amount of time stakeholders will have to analyze and plan for the effects of those rules. If these concerns are not appropriately addressed, they are likely to decrease the ability of commercial firms to use commodity derivatives to manage commercial risks, and, in the case of energy markets, are highly likely to result in increased costs for the ultimate consumers of energy products and decreased job opportunities. This reduction or elimination of involvement by commercial firms in commodity derivatives markets is likely to result in reduced competition in those markets. In the short-term, this reduction in competition would create decreased liquidity in commodity derivatives markets as commercial firms reduce their participation in those markets. In the long-term, this reduction in competition would create concentration of commodity derivatives transactions among the financial entities that have traditionally been recognized as swap dealers. Many of these are the firms that have been considered "too big to fail."

## II. HOW AND WHY COMMERCIAL FIRMS USE SWAPS.

Members of the Working Group are engaged in many aspects of the energy business, including: (1) the basic creation or manufacturing processes, such as exploring for, producing, and marketing crude oil and natural gas; refining feedstocks into gasoline and other products, and marketing those products; and generating and marketing electricity, including electricity from renewable projects such as wind and solar; (2) the logistical activities that are fundamental to the energy business, including storing energy commodities and moving energy commodities by tanker, pipeline, transmission line, or other means from source to market or from one market to another; and (3) the associated merchandising and trading of energy commodities.

All of these activities expose the Working Group's members to a wide array of commercial risks, including risks that are similar to those experienced by any commercial firm engaged in manufacturing or logistics, such as operational risk, market risk, and credit risk. Like agricultural firms, the Working Group's members differ from some manufacturing firms in that their basic energy products are commodities around which financial derivatives have been developed. Those derivatives allow each Working Group member to manage the level of commercial risk to which it is exposed, scaling the commercial risk that has been created through its primary business activity up or down to achieve the level of exposure to that risk that the firm believes is appropriate for its stakeholders. For example, commercial energy firms can use commodity derivatives to:

- Buy or sell necessary commodity products, including feedstocks, end products, and inventories, at predictable prices;
- Provide greater certainty for future cash flow from investments;

- Take market positions in the commodities in which they are active physical market participants; and
- Increase the ability to make economic investments in U.S. energy infrastructure and the development of energy resources.

## III. SPECIFIC ISSUES.

### A. The CFTC's Proposed Definition of "Swap Dealer" Could Result in Regulation of Commercial Energy Firms as Swap Dealers Where There is No Public Benefit

#### 1. The CFTC's proposed rule does not recognize a distinction between swaps used for "dealing" and "trading" purposes

The Dodd-Frank Act definition of "swap dealer" is based on four categories of activity that are comparable to the types of activities used to define "dealer" in the Securities Exchange Act of 1934. Based on that "dealer" definition, the SEC has applied a long-standing and well-known Dealer/Trader Distinction Rule. In general, the SEC's Dealer/Trader Distinction Rule recognizes that certain activities involving securities may at first appear to be dealing activities but are, in fact, trading activities, and that market participants engaging in such trading activities should not be regulated as dealers. There are significant similarities between the Dodd-Frank Act definition of "swap dealer" and the Securities Exchange Act of 1934 definition of "dealer"; however, the CFTC's proposed definition of "swap dealer" specifically rejects making a distinction between dealers and traders in commodity derivatives markets. The CFTC rejects the application of a dealer/trader distinction to these markets, which increases the likelihood of commercial energy firms being regulated as swap dealers, despite the fact that such firms use commodity derivatives to manage risks associated with their primary business activity of delivering physical energy commodities to others. The Working Group strongly recommends

that the CFTC implement a framework that distinguishes between dealers and market participants that use commodity derivatives for their own hedging or trading purposes.

### 2. The CFTC's proposed *de minimis* exception is so narrow that it will be unavailable to commercial energy firms that do engage in a relatively small amount of dealing activity

The Working Group believes Congress intended the *de minimis* exception to apply to any person that would otherwise be a swap dealer but for the fact that it engages in limited amounts of swap dealing or whose notional amount of exposure is small. The CFTC's proposed *de minimis* exemption included in the definition of "swap dealer" is so narrow that commercial firms that may engage in a relatively small amount of transactions in a swap dealing capacity will be unable to claim the exemption and will be subject to full regulation as swap dealers. As noted above, there is no public benefit to regulating such firms as swap dealers. The CFTC's proposal inexplicably provides that any entity who enters annually into more than twenty swaps, has more than fifteen counterparties, or enters into swaps with more than $100 million in notional amount is a swap dealer regardless of its regular business. Such interpretation essentially makes every market participant in the swap markets a swap dealer and renders the express statutory definition superfluous. The CFTC has proposed this limited *de minimis* exception even when data indicates that the largest 25 bank holding companies control more than 90 percent of the U.S. swaps market. An appropriate interpretation of "*de minimis*" would provide a meaningful exception for entities other than these traditional financial institutions. It was not the intent of Congress to create a *de minimis* exception that applies to no one.

### 3. An unnecessarily broad definition of "swap dealer" will harm commodity derivatives markets

The Working Group is concerned that an unnecessarily broad definition of "swap dealer" will harm the liquidity and efficiency of commodity derivatives markets. Efficiency requires that

regulations be designed to result in the least-cost approach to achieve a regulatory objective, and to ensure that the public benefit of those regulations is greater than the costs of those regulations. These costs include the costs for individual market participants to comply with regulations, public costs to implement and enforce the regulations, and the public and private costs created by the impact of the regulation on the regulated market and participants in that market.

Classification of commercial energy firms that use commodity derivatives as swap dealers would have significant implications for those firms, including:

- Applying capital and margin requirements that could consume or divert resources that might otherwise be available for infrastructure investment, including investment in the production of new energy resources; and
- Denying those firms the benefits of the end-user exception from mandatory (1) clearing and (2) on-facility execution of swaps.

Further, the excessive breadth of the definition of "swap dealer" will impose substantial additional and unnecessary burdens on regulators. A broad definition of "swap dealer" that results in regulation of commercial firms as swap dealers will result in a dilution of the CFTC's resources that will necessarily result in less oversight of large traditional swap dealers.

Commercial energy firms have not traditionally been considered swap dealers, do not cause systemic risk, and were not a cause of the financial crisis. The Working Group believes the CFTC has not justified the cost, relative to the public benefit, of a broad definition of "swap dealer," and should adopt a final definition of "swap dealer" that is tailored to regulate only those firms that truly function as swap dealers and not those firms that simply use commodity derivatives to manage commercial risks associated with their primary business activity of delivering physical commodities to others.

### B. The CFTC's Proposed Definition of "Major Swap Participant" Could Result in Regulation of Commercial Energy Firms Even When Those Firms Do Not Create Systemic Risk

The CFTC's proposed definition of "Major Swap Participant" is overly broad and is likely to result in companies that are not systemically risky being unnecessarily subject to prudential regulation. Despite the Dodd-Frank Act's limitation on the definition of "major swap participant" to entities that are "systemically important or can significantly impact the financial system of the United States," the CFTC has chosen to classify companies as major swap participants based upon fixed exposure thresholds that the Working Group believes fall well below levels that actually pose a risk to the U.S. financial system. Importantly, these thresholds do not appear to have any direct relationship to systemic risk and will not adjust to changing market prices. Even if one could assume that the current CFTC-proposed thresholds are reasonable in the present market, over time, as commodity prices fluctuate, the CFTC will have to routinely revisit these thresholds to make sure they comply with Congressional intent. The effort to monitor and adjust these thresholds will be another unnecessary use of the CFTC's resources. If commodity prices increase as they have over the past several months, more and more companies will reach these fixed thresholds despite the fact that the relative market positions of these companies would have largely remained unchanged. Because of these effects, the Working Group respectfully suggests that the CFTC should test the systemic risk of companies in ways that account for current market conditions. Evaluating exposures as a percentage of market value rather than by relying on fixed thresholds is one way to do this. Given that regulation of major swap participants is very similar to regulation of swap dealers, many of the negative effects of a definition of "swap dealer" that unnecessarily results in

regulation of commercial firms would also apply to unnecessary regulation of those firms categorized as major swap participants.

### C. Mandatory Clearing Will Not Reduce Risk – It Will Only Transform Counterparty Risk into Liquidity Risk

The Working Group believes that mandatory clearing will only succeed in transforming counterparty risk into liquidity risk. One benefit of the end-user exception to mandatory clearing is that commercial firms will be protected from this liquidity risk. However, if the definitions of "swap dealer" and "major swap participant" are unnecessarily broad and result in commercial firms being regulated as swap dealers or major swap participants, then those firms will be fully exposed to this liquidity risk.

Clearing reduces counterparty risk by requiring every party to a transaction to provide (1) full cash margin on the change in the value of the cleared portfolio every day and (2) initial margin sufficient to cover the potential movement in value between daily margin calls. Daily margin calls must be settled in cash, on very strict and short deadlines, and they apply to changes in value caused by ordinary market movement and those caused by extraordinary market events.

When the financial system is functioning smoothly, a commercial firm can manage liquidity requirements caused by ordinary market movement through capital reserves and access to lines of credit. However, liquidity requirements caused by extraordinary market events may require a diversion of capital from other uses. This admittedly is an extreme scenario, but it is precisely these extreme scenarios that must be analyzed to understand how the CFTC's proposed rules affect risk in the financial system.

When combined with the vagueness and potential breadth of the definitions of "swap dealer" and "major swap participant," the transformation of counterparty risk to liquidity risk and the exposure of commercial firms to this liquidity risk may actually thwart the policy goals of the

Dodd-Frank Act. The CFTC can avoid this by appropriately tailoring the definitions of "swap dealer" and "major swap participant" and not unnecessarily including commercial firms in either category of regulated entities.

### D. **The CFTC's Rulemaking Process Does Not Allow Stakeholders to Properly Consider the Interaction of the Rules Required for Regulation of Commodity Derivatives under Title VII of the Dodd-Frank Act**

Title VII represents a fundamental redesign of the regulatory regime applicable to commodity derivative markets, especially the commodity derivatives used by the Working Group's members to manage the risks associated with their primary business activity of delivering physical energy commodities to others. A threshold element of this redesign is the determination of which products and market participants will be regulated by the CFTC. Notwithstanding the CFTC's aggressive efforts to adopt all final rules required by the Dodd-Frank Act, as of March 29, 2011, the CFTC has not issued final rules defining "swap dealer" and "major swap participant," and it has not issued even a proposed definition of "swap." A direct result of the lack of final rules defining these key terms is that more than eight months after passage of the Dodd-Frank Act, market participants still do not know with any certainty the universe of entities and products that will be subject to regulation under Title VII's provisions relating to commodity derivatives. Without full knowledge of which entities will be regulated as swap dealers and major swap participants and which products will be regulated as swaps, the Working Group's members and other commercial energy firms are not able to determine the impact of these rules on their businesses. This uncertainty is likely to result in disruption of energy markets and could have negative consequences on the broader economy, including, but not limited to, increased prices for ultimate consumers of those products. Such consequences are avoidable. Given the complexity of the rulemaking process, the Working Group believes it is

imperative that the CFTC allow interested parties a period of time to analyze and comment on all of the rules proposed under Title VII of the Dodd-Frank Act in the aggregate. Further, once the CFTC issues final rules, the Working Group believes market participants should be given adequate time to evaluate their compliance obligations, and to design and implement measures to meet such obligations in an efficient manner. Many of these rules will require time-consuming and expensive changes to systems and processes, so reasonable compliance deadlines are critical.

## IV. CONCLUSION.

In closing, the Working Group restates its support for the policy goals of the Dodd-Frank Act to promote the financial stability of the United States by improving accountability and transparency in the financial system and to reduce systemic risk. Under Title VII of the Dodd Frank Act, the CFTC has been asked to take on a significant amount of new regulatory oversight for derivative markets and derivative market participants. The Working Group appreciates the diligent efforts of the CFTC and its staff to understand our businesses and the markets in which we operate. However, if the CFTC's rules to implement Title VII of the Dodd-Frank Act are not designed to appropriately regulate commodity derivatives markets and if those rules are not implemented in a coordinated and prudent manner, commercial energy firms may either be subject to unnecessary and costly regulation or will reduce their use of commodity derivatives to manage commercial risks, each of which could ultimately result in increased energy costs for consumers.

I thank the Committee for the opportunity to present this testimony on behalf of the Working Group of Commercial Energy Firms and I will be pleased to answer any questions.

**Committee on Agriculture**
**U.S. House of Representatives**
**Required Witness Disclosure Form**

**House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2008.**

**Name:** James C. Allison

**Organization you represent (if any):** Working Group of Commercial Energy Firms

1. **Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2008, as well as the source and the amount of each grant or contract. House Rules do NOT require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

**Source:** ______ **Amount:** ______

**Source:** ______ **Amount:** ______

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2008, as well as the source and the amount of each grant or contract:**

**Source:** ______ **Amount:** ______

**Source:** ______ **Amount:** ______

**Please check here if this form is NOT applicable to you:** X

**Signature:** [signature]

* Rule XI, clause 2(g)(4) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

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Committee on Agriculture
U.S. House of Representatives
Information Required From Nongovernmental Witnesses

House rules require nongovernmental witnesses to provide their resume or biographical sketch prior to testifying. If you do not have a resume or biographical sketch available, please complete this form.

1. Name: James C Allison

2. Organization you represent: Working Group of Commercial Energy Firms

3. Please list any occupational, employment, or work-related experience you have which add to your qualification to provide testimony before the Committee:
   Risk Manager, Gas and Power N.America, ConocoPhillips, 2002-Present
   Risk Manager, Conoco Inc., 2001-2002
   Manager, Financial Analysis, Conoco Inc., 1990-2001

4. Please list any special training, education, or professional experience you have which add to your qualifications to provide testimony before the Committee:
   MBA, University of Virginia, 1982
   BA, Mathematics, Princeton University, 1976

5. If you are appearing on behalf of an organization, please list the capacity in which you are representing that organization, including any offices or elected positions you hold: Member Representative

PLEASE ATTACH THIS FORM OR YOUR BIOGRAPHY TO EACH COPY OF TESTIMONY.