Testimony of Andrew K. Soto
American Gas Association

Before the U.S. House of Representatives
Committee on Agriculture
Subcommittee on General Farm Commodities and Risk Management
The Future of the CFTC: End-User Perspectives

July 24, 2013

Chairman Conaway, Ranking Member Scott and members of the committee, I am Andrew K .Soto, Senior Managing Counsel for Regulatory Affairs at the American Gas Association (AGA). Founded in 1918, AGA represents more than 200 local energy companies that deliver clean natural gas throughout the United States. More than 65 million residential, commercial and industrial natural gas customers, or more than 175 million Americans, receive their gas from AGA members. In my role at AGA, I represent the interests of AGA's members before a variety of Federal agencies, including the Commodity Futures Trading Commission (CFTC).

Thank you for inviting me to appear before you today on the issue of the impact of the CFTC's implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act on non-financial entities or end-users. AGA member companies are end-users of futures and swaps in that they use such financial instruments to hedge and mitigate their commercial risks, in particular price volatility associated with procuring natural gas commodity supplies for their customers. AGA members have an interest in transparent and efficient financial markets for energy commodities, so that they can engage in risk management activities at reasonable cost for the benefit of America's natural gas consumers. We believe Congress intended in the Dodd-Frank Act to protect end-users' ability to use financial transactions to hedge and mitigate commercial risk in recognition of the fact that non-financial end-users did not cause the financial crisis that led to the passage of the Dodd-Frank Act and pose little or no systemic risk to the financial system.

My testimony will address three areas. First, I will explain the importance of transparent and efficient financial markets to gas utilities that procure and deliver clean, affordable natural gas to their customers. Second, I will address the impact of the CFTC's implementation of the Dodd-Frank Act on gas utilities' ability to enter into financial and physical contracts to manage commercial risks associated with the business of procuring natural gas. Third, I will recommend administrative process reforms, which we believe will help make the CFTC a more responsive regulator and provide additional avenues to obtain regulatory certainty, which is essential for business planning and compliance.

Gas Utility Reliance On Financial Markets

AGA member companies provide natural gas service to retail customers under rates, terms and conditions that are regulated at the local level by a state commission or other regulatory authority with jurisdiction. Each year, natural gas utilities develop seasonal plans to reliably meet the gas supply needs of their retail customers. Gas utilities build and manage a portfolio of physical gas supplies and services in order to meet anticipated demand. A portfolio of assets and contracts may include natural gas supply contracts, pipeline transportation storage and no-notice services, and on-system assets such as natural gas storage, liquefied natural gas storage, and propane air storage. Because a significant portion of customer demand is weather driven, gas utilities cannot know with certainty when, or even if, a certain amount of the gas supplies they make plans to have access to will be needed. Gas utilities, therefore, typically enter into certain gas supply contracts with flexible delivery terms as part of their supply portfolios in order to meet demand swings driven by variable customer loads throughout the season or year. Factors affecting variable loads include expected and unexpected volatility in customer demand, weather events, constraints or disruptions to alternative sources of supply, and heightened seasonal (winter) demand fluctuations. Flexible delivery terms are an essential element of some of the gas supply contracts used to meet variable system load requirements.

Gas utilities have a strong interest in managing their supply portfolios to ensure that the overall cost for natural gas service remains stable and at a reasonable cost to their customers. Gas utilities are commercial entities exposed to commodity risks, most especially the price of natural gas commodities. In addition to their physical transaction activities, many gas utilities use a variety of financial tools such as futures and financial derivatives or "swaps" to hedge

against volatility in natural gas commodity costs. In general, gas utilities forecast the anticipated demand on their systems and assess the underlying physical exposure associated with that demand. Many gas utilities then determine if financial instruments are appropriate to mitigate all or a portion of that exposure. Some gas utilities are required by state regulatory agencies to hedge a portion of forecasted demand to manage potential price volatility. These activities are not speculative in nature; rather, gas utilities enter into financial transactions to hedge or mitigate commercial risk associated with forecasted demand. As such, the financial transactions of gas utilities pose little or no systemic risk to the financial markets.

End-User Issues with CFTC Implementation of the Dodd-Frank Act

As noted above, regulatory certainty is essential for business planning and compliance. To illustrate the difficulty energy end-users like gas utilities have encountered in preparing to comply with the CFTC's regulations implementing the Dodd-Frank Act, let me use the agency's definition of a "swap" as an example. At the outset, it is important to note that the entire foundation of the CFTC's regulation of the financial derivatives market rests on what is or is not considered a "swap." Who is or is not a swap dealer or major swap participant, what transactions are required to be cleared, what transactions are required to be reported, what transactions are subject to position limits, *etc.*, all rest on the definition of a "swap." Many parties, including AGA, initially suggested that the CFTC define "swap" at the beginning of its implementation of the Dodd-Frank Act, so that market participants would have a clear understanding of the scope of the regulations as the whole regulatory framework was being developed. Instead, the CFTC did not issue a final rule defining "swap" until August 2012, more than two years after the Act was passed, and issued only an "interim" final rule at that. Even now, toward the end of its process, the CFTC has yet to define the parameters of its "swap" definition in a manner that can be clearly and consistently applied within the gas industry.

To give you a better sense of what is at stake, let me walk through the development of the "swap" definition as it relates to natural gas market participants. In August 2010, the CFTC issued an Advance Notice of Proposed Rulemaking,[1] requesting public comment on the key definitions that would be used to establish the framework for regulating swaps. The proposal did little more than reference the statutory definition of "swap," providing no views on what the

[1] *Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act*, 75 Fed. Reg. 51429 (Aug. 20, 2010).

agency considered the scope of the definition to be. After a round of public comment, in May 2011, the CFTC issued a Proposed Rule and Proposed Interpretations regarding the "swap" definition.[2] There, the CFTC proposed to exclude forward contracts in non-financial commodities from the definition of a "swap" under the Dodd-Frank Act, consistent with its historical interpretation of the forward contract exclusion under the Commodity Exchange Act. The CFTC explained that forward contracts with respect to non-financial commodities were commercial merchandising transactions where the primary purpose is to transfer ownership of the commodity and not to transfer solely the price risk. The CFTC noted that it had previously established an Energy Exemption for certain types of transactions that were not considered futures. The CFTC then proposed an interpretation to withdraw as unnecessary this Energy Exemption.

The CFTC believed that the statutory definition of "swap" explicitly provided that commodity options are "swaps." Thus, for non-financial commodity options embedded in forward contracts, the CFTC established a three-part test. The CFTC explained that a transaction will be considered an excluded forward contract (and not a swap) where the non-financial embedded option: (1) may be used to adjust the forward contract price, but does not undermine the overall nature of the contract as a forward contract; (2) does not target the delivery term, so that the predominant feature of the contract is actual delivery; and (3) cannot be severed and marketed separately from the overall forward contract in which it is embedded. The CFTC added that conversely, where the embedded option renders delivery optional, the predominant feature of the contract cannot be actual delivery, and the embedded option to not deliver precludes treatment of the contract as a forward contract. The CFTC then sought public comment on all aspects of its proposed definitions and interpretations.

The CFTC's proposed rule generated considerable confusion in the natural gas industry as market participants began to wonder whether their commercial merchandising transactions, particularly those with flexible delivery terms, would be considered "swaps" under the CFTC's proposed interpretation. Numerous comments were filed seeking clarification as to whether particular types of transactions would be considered "swaps." AGA, for its part, filed comments explaining that gas utilities enter into physical gas supply transactions with flexible delivery

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[2] *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement,"; "Mixed Swaps; Security-Based Swap Agreement Recordkeeping,"* 76 Fed. Reg. 29818 (May 23, 2011).

terms as important elements of their ability to meet their customers' needs at a reasonable cost. Because gas consumption to residential and commercial customers is largely weather-driven (consumption increases as the weather gets colder) and predicting the weather is not an exact science, gas supply contracts with delivery flexibility help AGA members make sure gas supplies are, or can be made, available when the customers actually need the gas without having to pay excessively higher prices at the actual time of need and/or other fees associated with pipeline imbalance penalties.

In August 2012, almost two years later, the CFTC issued an interim final rule, further interpretations, and a request for comment on the interpretations.[3] The CFTC provided additional guidance on the scope of its forward contract exclusion. In particular, the CFTC established a seven-part test that it would apply in determining whether a contract with flexible delivery terms would be regulated as a "swap" or excluded as a forward contract. The CFTC then provided further interpretations responding to the requests to clarify whether certain types of transactions would be considered, and regulated as, "swaps." Notably, the CFTC sought to clarify that certain physical commercial transactions for natural gas pipeline transportation and storage service agreements would not be considered options, and thus would not be regulated as "swaps," if they met a three-part test. However, the CFTC added that if such transportation and storage agreements employed a certain two-part rate structure, such agreements would be considered options subject to swap regulation. The CFTC then believed that these interpretations would benefit from further public input and requested additional comments.

More confusion reigned. Was the rule final or only interim? How should the seven-part test be applied? What do some of the elements mean? Did the CFTC really intend to regulate as "swaps" all natural gas pipeline transportation and storage agreements with two-part rates? Again, numerous comments were filed seeking clarification of the CFTC's rules and interpretations. Many comments focused on whether pipeline transportation and storage agreements, long regulated exclusively by the Federal Energy Regulatory Commission (FERC) under the Natural Gas Act, would be considered options and subject to the CFTC's swap regulations. In November 2012, the CFTC's Office of General Counsel (OGC) issued a Response to Frequently Asked Questions Regarding Certain Physical Commercial Agreements

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[3] *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48208 (Aug. 13, 2012).

for the Supply and Consumption of Energy. In essence, OGC staff stated that if a pipeline transportation or storage agreement with a two-part rate structure met an additional five-part test, the transaction would not be considered an option and thus not subject to regulation as a "swap." Apart from this staff action aimed solely at clarifying the two-part rate issue for pipeline transportation and storage contracts, the CFTC has not acted on the comments it received in response to its request for further public input on the "swap" definition and interpretations.

Relatedly, in April 2012, the CFTC issued an interim final rule holding that certain commodity options would be considered "trade options" if they met a three-part test. Trade options, while regulated by the CFTC, would not be subject to the full panoply of regulations established for "swaps." Notably, trade options would be subject to significantly less intense reporting requirements for counterparties that are not already required to report their swaps. Once again, several comments were filed in response to the interim final rule, yet the CFTC has not issued any further interpretations or clarifications regarding trade options, although the CFTC's staff has issued no-action relief regarding trade option reporting.

In the absence of clear guidance from the CFTC, numerous parties, including AGA, have filed requests for interpretive guidance and/or no-action relief from CFTC staff as deadlines for reporting and other compliance obligations have approached. Many of these requests remain outstanding and have not been acted upon by the CFTC or its staff.

Where does that leave us? There remain disagreements and confusion within the natural gas industry as to which types of gas supply transactions, if any, will be subject to CFTC regulation. These transactions are normal commercial merchandising transactions that parties use to buy and sell natural gas for ultimate delivery to end-use customers. They would not normally be considered speculative, financial transactions as the parties contemplate physical delivery of the commodity. Nevertheless, transactions that contain some option or choice for one or the other counterparty, raise questions for some as to whether they would be considered commodity options regulated as swaps, meet a three part test and a seven-part test to be excluded as options embedded in forward contracts, be viewed as trade options subject to a lessened reporting burden, or be considered facility use agreements that meet a three-part test and then a five-part test and not subject to regulation at all. Some counterparties in the industry have taken the view that regardless of whether a transaction would satisfy the seven-part test for options embedded in forward contracts, they will report all such transactions as trade options

out of an abundance of caution to avoid the risk of a violation of the CFTC's rules. Other counterparties have insisted upon contract provisions to force agreement as to the regulatory treatment of the transaction. Some AGA member companies, in the normal course of business, have entered into routine transactions with multiple counterparties where the different counterparties have conflicting regulatory interpretations of what are essentially identical contracts. Thus, normal contracting practices in the natural gas industry have been seriously disrupted.

Until the CFTC provides definitive rules clarifying the regulatory treatment of these transactions, turmoil in the industry will continue. Moreover, the different interpretations and understandings of the CFTC's scope of the "swap" definition is, and will continue to, lead to inconsistent reporting of swap transactions to swap data repositories and to the CFTC.

Administrative Process Reforms

AGA and its members have been frustrated in their efforts to obtain regulatory certainty from the CFTC in its implementation of the Dodd-Frank Act. Uncertainty with regard to something so fundamental to derivatives regulation as what is and what is not a "swap," is hampering business planning and compliance and disrupting contracting practices in the industry. It also hampers the CFTC's ability to be an effective market monitor and regulator. AGA believes that the CFTC and the industry would benefit greatly from additional administrative processes whereby industry participants could obtain in a timely manner the kind of regulatory certainty they need for business planning and compliance, and could challenge agency action if necessary. In particular, we offer the following recommendations:

First, AGA recommends that Congress amend the Commodity Exchange Act (CEA) to provide clear and defined procedures for challenging CFTC rules and orders in court. Although the CEA currently contains provisions allowing for judicial review by a U.S. Court of Appeals of certain agency actions, the provisions are very limited and provide no defined avenue for challenging CFTC rules and orders generally. A broad judicial review provision allowing for the direct challenge of CFTC rules and orders would have both a rehabilitative effect on the current process and a prophylactic effect on future agency action. Specific judicial review provisions would allow interested parties to challenge particular agency actions that are unreasonable and hold the CFTC accountable for its decisions. In addition, judicial review would have an

important prophylactic effect by requiring the agency to think through its decisions before they are made to ensure that they are sustainable in court, thus enabling the agency to be a more conscientious and prudent regulator. In the absence of specific judicial review provisions, the general review provisions of the Administrative Procedure Act (APA) would apply, requiring parties seeking to challenge CFTC rules to file a claim before a U.S. District Court, move for summary judgment (as a hearing would likely be unnecessary), obtain a ruling and then, if necessary, seek further judicial review before a U.S. Court of Appeals. In the recent litigation over the CFTC's position limits rule, which followed the review provisions of the APA, the CFTC's General Counsel acknowledged the efficiency and desirability of direct review by the U.S. Court of Appeals of agency rules, and stated that the agency would have no objection to such direct review assuming Congress were to authorize it.[4] Accordingly, provisions allowing for direct review by a U.S. Court of Appeals of rules and orders of the CFTC would enable both the industry and the agency to benefit from the administrative economy, procedural efficiency and certainty of having a dedicated forum in which agency decisions are reviewed.

Second, and relatedly, AGA recommends that Congress provide direct judicial review of jurisdictional disputes between the CFTC and the FERC. In the Dodd-Frank Act, Congress directed the two agencies to enter into a Memorandum of Understanding within 180 days of enactment of the legislation, in order to resolve conflicts concerning overlapping jurisdiction and to avoid, to the extent possible, conflicting or duplicative regulations.[5] More than three years has passed, and no such memorandum has been negotiated by the two agencies. For energy end-users such as AGA's member gas utilities, the main source of frustration with the CFTC's implementation of the Dodd-Frank Act has been the lack of regulatory certainty as to whether physical transactions traditionally regulated by FERC would now be subject to CFTC regulation as "swaps." Industry participants would benefit greatly by clearly defined scopes of jurisdiction as between the two agencies. Congress has already provided mechanisms for the judicial

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[4] *See* Motion of Respondent to Dismiss for Lack of Subject Matter Jurisdiction, Doc. #1350987 at pp. 2, 4, *International Swaps and Derivatives Ass'n et al. v. CFTC*, No. 11-1469 (D.C. Cir. 2012) (stating that "direct review in [the U.S. Court of Appeals] would serve the interests of judicial economy" and that "the Commission recognizes the benefits of direct appellate review in these circumstances and would have no objection to such review."); Reply of Respondent in Further Support of Motion to Dismiss, Doc. #1353103 at pp. 2 n.1, *International Swaps and Derivatives Ass'n et al. v. CFTC*, No. 11-1469 (D.C. Cir. 2012).

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. No. 111-203, § 720 (2010).

review of disputes between the CFTC and the SEC regarding swaps and security-based swaps (Section 712(c))[6] and novel derivative products that may have elements of both securities and futures (Section 718).[7] We encourage Congress to provide similar mechanisms with regard to jurisdictional issues as between the CFTC and the FERC.

Third, AGA recommends that Congress require the CFTC to provide better administrative processes for interested parties to seek clarity and guidance on agency issues. Under current CFTC rules, there are insufficient avenues available for the public to obtain timely, definitive guidance in the form of final agency action, particularly as to the impacts of the CFTC's regulations on commercial end-users. As a result, parties have relied on staff action in the form of no-action or exemptive relief, interpretive guidance, and/or interpretations by the General Counsel to obtain necessary clarifications of the agency's rules. These avenues are less than satisfying in that they reflect only the views of staff and not those of the Commissioners themselves. The CFTC should provide commercial market participants with specified administrative processes in which to obtain definitive guidance from the agency on a timely basis.

AGA believes that the inclusion of administrative process reforms in the CFTC's governing statutes and rules would have a positive impact on the agency's ability to be a responsive and effective regulator. AGA would be pleased to provide the Committee with supplemental information on specific mechanisms to achieve these goals.

Thank you for your consideration of these comments.

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[6] Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. No. 111-203, § 712 (2010).

[7] Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. No. 111-203, § 718 (2010).

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, 2010.

Name: Andrew K. Soto

Organization you represent (if any): American Gas Association

1. **Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2010, 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: NONE **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, 2010, as well as the source and the amount of each grant or contract:**

Source: NONE **Amount:** _____

Source: _____ **Amount:** _____

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

Signature: Andrew K. Soto

* Rule XI, clause 2(g)(5) 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.*

PLEASE ATTACH DISCLOSURE FORM TO EACH COPY OF TESTIMONY.

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: Andrew K. Soto

2. Organization you represent: American Gas Association

3. Please list any occupational, employment, or work-related experience you have which add to your qualification to provide testimony before the Committee: Please see the attached.

4. Please list any special training, education, or professional experience you have which add to your qualifications to provide testimony before the Committee: Please see the attached.

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: Senior Managing Counsel, Regulatory Affairs

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

Andrew K. Soto is Senior Managing Counsel for Regulatory Affairs at the American Gas Association, representing AGA's natural gas distribution member companies before the U.S. Department of Energy, the Federal Energy Regulatory Commission, the Commodity Futures Trading Commission, and other Federal agencies and U.S. courts. Mr. Soto advises member companies on regulatory and legislative developments that affect gas utility interests and advocates on their behalf on a broad range of policy issues, involving the regulation of physical and financial natural gas markets and Federal energy conservation standards.

Before joining AGA, Mr. Soto was counsel in the law firm of Sutherland Asbill & Brennan LLP, where he advised clients on regulatory policy developments and compliance in several energy industries including natural gas. Prior to that, Mr. Soto was Senior Legal Advisor to Chairman Pat Wood, III, of the Federal Energy Regulatory Commission. While there, Mr. Soto advised the chairman on the full gamut of issues before the Commission. Prior to joining the Chairman's staff, Mr. Soto represented FERC in complex appellate litigation before U.S. Courts of Appeals in all areas of Commission regulation.

Mr. Soto was previously in private practice at Ball Janik, LLP, and Newman & Holtzinger, PC, and worked in the Office of Administrative Law Judges, U.S. Department of Labor. Mr. Soto received a J.D. from Villanova University School of Law and a B.A. from Franklin & Marshall College.