

TESTIMONY OF DAVE SCHRYVER
EXECUTIVE VICE PRESIDENT
THE AMERICAN PUBLIC GAS ASSOCIATION
BEFORE THE HOUSE AGRICULTURE COMMITTEE
SEPTEMBER 17, 2009

Chairman Peterson, Ranking Member Lucas and Members of the Committee, I appreciate this opportunity to testify before you today and I thank the Committee for calling this hearing to review proposed legislation by the U.S. Department of Treasury regarding the regulation of over-the-counter derivatives markets. My name is Dave Schryver and I am the Executive Vice President for the American Public Gas Association (APGA).

I testify today on behalf of the 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, other abusive market conduct or excessive speculation.

Over the past several years, and leading up to the passage of the 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 in natural gas. APGA previously testified before this Committee that APGA’s members have 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

¹ Food, Conservation, and Energy Act of 2008, PL 110-246, 122 Stat. 2189, Title XIII.

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 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 contract² and is thereby 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

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)

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.

The Treasury Proposal on Regulating OTC Derivatives

However, we have also noted to the Committee in prior testimony that we believed that it was likely that it would be necessary for Congress to provide the CFTC with additional statutory authorities to respond fully and effectively to the issues raised by trading in the energy markets. We have expressed the view to Congress that 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 believes that the proposed legislation by the U.S. Department of Treasury, the "Over-the-Counter Derivatives Markets Act of 2009," ("Treasury Proposal"), offers Congress a constructive basis for addressing many of the issues that remain open following enactment of the Reauthorization Act. Accordingly, APGA supports fully many of the provisions suggested by the Treasury Proposal, particularly those relating to reporting of large positions in OTC transactions and the application of speculative position limits to such contracts. 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. APGA also supports the Treasury Proposal's nuanced approach to mandated clearing of OTC contracts. At the same time, we note that certain recommendations to this Committee with respect to mandatory clearing of all transactions would have serious, negative consequences to our members. We will address each of these issues in turn.

The Treasury Proposal seeks to apply a regulatory framework to trading in OTC swaps. Many public gas systems use both or either the OTC derivatives markets and regulated futures markets to hedge their exposures related to their purchases and sales of natural gas. As publicly-owned distribution systems, the savings that public gas systems realize from hedging their purchases and sales of natural gas using exchange-traded or OTC derivatives directly lowers the rates paid by their customers. Thus, the proper functioning of the markets is important to public gas systems because well-functioning markets affect the rates that their consumers will ultimately pay.

APGA believes that the goal of Treasury's Proposal to close regulatory loopholes and bring needed regulatory oversight to the OTC markets is sound. In light of the importance of these markets to public gas systems, and ultimately to their customers, we endorse the goal of Treasury's Proposal, generally, including the expectation that regulatory agencies will cooperate in overseeing the OTC derivatives markets.

Mandatory Clearing.

Section 713 of the Treasury Proposal requires the clearing of standardized swap contracts by a derivatives clearing organization except if no derivatives clearing organization will clear the transaction, or one of the counterparties is not a dealer or a “major swaps participant and does not meet the eligibility qualifications of a derivatives clearing organization. A major swap participant is defined as an entity that maintains a substantial net swap position other than to create and maintain a hedge under generally accepted accounting principles, or as the CFTC and SEC further define by rule.

APGA supports this exemption from the mandated clearing requirement. As hedgers, with very high credit ratings, assured collections from rate payers, and substantial assets in physical infrastructure, public gas systems under current practice in the bi-lateral swaps market often are not required to pledge liquid collateral for transactions below agreed upon levels. 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. 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.

Accordingly, APGA strongly supports the inclusion of the exemption for hedgers which are not major swap participants. The availability of this exemption is critical to our member's ability to continue to bring natural gas to their customers at the lowest possible cost in a fiscally sound and operationally efficient manner.

However, we suggest that the definition of "major swap participant" be revised. Currently, the definition is tied to a finding that the net position of outstanding swaps is an effective hedge under generally accepted accounting principles (GAAP). APGA members use the OTC derivatives markets to hedge their physical operations. We are concerned that an overly rigorous interpretation of this definition may require tying particular swaps transactions to particular physical requirements. We suggest that the definition of "non-major swap participant" address this concern by being revised to include a category for "an entity which is a commercial user, processor or distributor of the physical commodity that enters into swap contracts in connection with their purchase or sales of the physical commodity."

There have been some who have suggested that Congress should not include this exemption in a final bill, and mandate that all standardized OTC derivatives be required to be cleared regardless of the nature of the end-user counterparty.

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. As noted above, under current practices in the OTC markets, many APGA based upon their very-high credit worthiness are not required to post collateral for an agreed upon number of transactions. In contrast, the mandated clearing of all OTC transactions would require public gas systems to post initial margin for all transactions and 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.

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 ours, 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 any problem which has brought about the current financial crises. From our perspective, the continued availability of individually negotiated, non-cleared OTC transactions will provide our Members the widest range of tools to continue to offer natural gas at the best possible prices to their customers.

Speculative Position Limits

Section 723 of the Treasury Proposal would make the Commodity Exchange Act's speculative position limit provisions applicable to any swaps that perform or affect a significant price discovery functions with respect to regulated markets. Such limits may be aggregated across positions held in designated contract markets, contracts on a foreign board of trade, or swaps serving a significant price discovery function with respect to a regulated market.

As hedgers that use both the regulated futures markets and the OTC energy markets, our members value the role of speculators in the markets. We also value the different needs served by the regulated futures markets and the more tailored OTC markets. As hedgers, we depend upon liquid and deep markets in which to lay off our risk. Speculators are the grease that provides liquidity and depth to the markets.

However, speculative trading strategies may not always have a benign effect on the markets. For example, the dramatic blow-up of Amaranth Advisors LLC and the impact it had upon prices exemplifies the impact that speculative trading interests can

have on natural gas supply contracts for local distribution companies (“LDCs”). Amaranth reportedly accumulated excessively large long positions and complex spread strategies far into the future. The Report by the Senate Permanent Committee on Investigations affirmed that “Amaranth’s massive trading distorted natural gas prices and increased price volatility.”³ APGA believes that these price distortions directly increased the cost of natural gas for many of our member’s customer rate payers.⁴⁵

Applying Aggregate Position Limits Across all Postions.

The Treasury Proposal would apply speculative position limits across all economically linked instruments, regardless of whether they are exchange-traded or traded OTC. The determination of whether to apply position limits consistently across all markets and participants is perhaps the single most important issue for the energy market. As we noted above, the various market segments for energy contracts are economically linked, and actions in one market segment can affect prices in the other segments. Recent

³ See “*Excessive Speculation in the Natural Gas Market*,” Report of the U.S. Senate Permanent Subcommittee on Investigations (June 25, 2007) (“PSI Report”) at p. 119

⁴ Many natural gas distributors locked in prices prior to the period Amaranth collapsed at prices that were elevated due to the accumulation of Amaranth’s positions. They did so because of their hedging procedures which require that they hedge part of their winter natural gas in the spring and summer. Accordingly, even though natural gas prices were high at that time, it would have been irresponsible (and contrary to their hedging policies) to not hedge a portion of their winter gas in the hope that prices would eventually drop. Thus, the elevated prices which were a result of the excess speculation in the market by Amaranth and others had a significant impact on the price these APGA members, and ultimately their customers, paid for natural gas. The lack of transparency with respect to this trading activity, much of which took place in the OTC markets, and the extreme price swings surrounding the collapse of Amaranth have caused bona fide hedgers to become reluctant to participate in the markets for fear of locking-in prices that may be artificial.

⁵ The additional concern has been raised that recent increased amounts of speculative investment in the futures markets generally have resulted in excessively large speculative positions being taken that due merely to their size, and not based on any intent of the traders, are putting upward pressure on prices. The argument made is that these additional inflows of speculative capital are creating greater demand than the market can absorb, thereby increasing buy-side pressure which results in advancing prices.

events in the economically linked markets for natural gas have shown the danger of traders being able to move positions from one market to another in order to evade application of a market's position accountability rule or position limit.⁶ A unified limit administered by the Commission across all markets, including the OTC markets (in addition to the limits adopted and administered by each separate market) would effectively address this issue and provide an effective and meaningful limitation on the total size of positions that a trader could amass in the delivery month.

APGA strongly supports the use of spot month speculative position limits as a proven and effective tool for addressing markets with constrained deliverable supplies, which is typical of the markets for natural gas. The CFTC recently promulgated rules implementing the Reauthorization Act's provisions with respect to the oversight of SPDCs.⁷ APGA believes that the final rules are a very good foundation for addressing the issue, but recommends that the CFTC consider taking additional steps within its existing statutory authority to strengthen the effectiveness of this important regulatory tool.

In this regard, APGA notes that the CFTC deferred action to make spot month speculative position limits or back month position accountability apply to both cleared and non-cleared transactions on a market that operates as a SPDC. Despite recognition of the important role that non-cleared transactions play in price formation, the speculative position limits that the Commission's rules require apply only to cleared transactions and

⁶ See generally, *PSI Report*

⁷ "Significant Price Discovery Contracts on Exempt Commercial Markets; Final Rule," 74 *Fed. Reg.* 12178 (March 23, 3009).

do not require that non-cleared transactions be included in calculating whether a trader has violated a spot month speculative position limit. This clearly and inexplicably weakens the prophylactic protection that spot month speculative position limits are intended to provide. Accordingly, APGA suggests that the Commission use its current statutory authority and include linked, non-cleared SPDCs within the speculative position limit requirement.

The Treasury Proposal would address this regulatory gap by expressly providing that speculative positions limits shall apply to swaps that serve a significant price discovery function with respect to a regulated contract. APGA considers it vitally important that any legislative proposal include unified speculative positions limits for contracts that are traded and maintained OTC. Where such contracts are economically linked to contracts traded on exchange traded or exempt commercial markets, such OTC contracts may have an important influence on pricing and on the performance of other market segments.

Recent events in the economically linked markets for natural gas have shown the danger of traders being able to move positions from one market to another in order to evade application of a market's position accountability rule or position limit.⁸ A unified limit administered by the Commission across all markets (including OTC transactions), in addition to the limits adopted and administered by each separate market would effectively address this issue and provide an effective and meaningful limitation on the total size of positions that a trader could amass in the delivery month.

⁸ *See PSI Report*

Large trader reporting

Section 731 of the Treasury Proposal would add a new provision requiring persons holding swaps positions in swaps that perform a significant price discovery function in respect of a regulated market which exceed a stated size to report to the CFTC such information as the CFTC shall require. This mirrors the requirement which underpins the current CFTC Large Trader Reporting System. The provision includes a books and records requirement.

The current lack of transparency with respect to large OTC transactions leaves regulators unable to answer questions regarding speculators' possible impacts on the over-all market. Without being able to see a large trader's entire position, the effect of a large OTC trader on the regulated markets is masked, particularly when that trader is counterparty to a number of swaps dealers that in turn take positions in the futures market to hedge these OTC exposures as their own.

The primary tool used by the CFTC to detect and deter possible manipulative activity in the regulated futures markets is its large trader reporting system. Using that regulatory framework, the CFTC collects information regarding the positions of large traders who buy, sell or clear natural gas contracts on the regulated market. The CFTC in turn makes available to the public aggregate information concerning the size of the market, the number of reportable positions, the composition of traders (commercial/non-commercial)

and their concentration in the market, including the percentage of the total positions held by each category of trader (commercial/non-commercial).

The CFTC also relies on the information from its large trader reporting system in its surveillance of the regulated market. In conducting surveillance of the regulated natural gas futures market, the CFTC considers whether the size of positions held by the largest contract purchasers are greater than deliverable supplies not already owned by the trader, the likelihood of long traders demanding delivery, the extent to which contract sellers are able to make delivery, whether the futures price is reflective of the cash market value of the commodity and whether the relationship between the expiring future and the next delivery month is reflective of the underlying supply and demand conditions in the cash market.

The CFTC Reauthorization Act, recently empowered the CFTC to collect large trader information with respect to “significant price discovery contracts.” However, there remain significant gaps in transparency with respect to trading of OTC energy contracts, including many forms of contracts traded on the Intercontinental Exchange, Inc. Despite the links between prices for the regulated futures contract and the OTC markets in natural gas contracts, this lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for participants to engage in manipulative or other abusive trading strategies with little risk of early detection and for problems of potential market congestion to go undetected by the CFTC until after the damage has been done to the market, ultimately costing the consumers or producers of natural gas.

More profoundly, it leaves the regulator unable to assemble a true picture of the over-all size of a speculator's position in a particular commodity.

Our members, and the customers served by them, believe that although the Reauthorization Act goes a long way to addressing the issue, there is not yet an adequate level of market transparency under the current system. This lack of transparency has led to a continued lack of confidence in the natural gas marketplace. Although the CFTC operates a large trader reporting system to enable it to conduct surveillance of the futures markets, it cannot effectively monitor trading if it receives information concerning positions taken in only one, or two, segments of the total market. Without comprehensive large trader position reporting, the government will remain handicapped in its ability to detect and deter market misconduct or to understand the ramifications for the market arising from unintended consequences associated with excessive large positions or with certain speculative strategies. If a large trader acting alone, or in concert with others, amasses a position in excess of deliverable supplies and demands delivery on its position and/or is in a position to control a high percentage of the deliverable supplies, the potential for market congestion and price manipulation exists. Similarly, we simply do not have the information to analyze the over-all effect on the markets from the current practices of speculative traders.

Over the last several years, APGA has pushed for a level of market transparency in financial contracts in natural gas that would routinely, and prospectively, permit the CFTC to assemble a complete picture of the overall size and potential impact of a trader's

position irrespective of whether the positions are entered into on a regulated futures exchange, on an exempt electronic market or through bi-lateral OTC transactions, which can be conducted over the telephone, through voice-brokers or via electronic platforms.

The Treasury Proposal addresses this regulatory gap by including all economically linked contracts that affect price discovery in the regulated market within a large trader reporting system. APGA strongly backs this proposal. We note that this is necessary in order to achieve meaningful transparency in the market. We believe that this would give the cop on the beat the tools necessary to patrol for manipulation, abuse, congestion, and price distortions. We urge that this provision be included in any financial reform legislation.

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In order to protect consumers the regulators must be able to (1) detect a problem before harm has been done to the public through market manipulation or price distortions; (2) protect the public interest; and (3) ensure the price integrity of the markets. Accordingly, APGA and its over 720 public gas system members applaud your continued oversight of the futures and related markets for natural gas markets. We look forward to working with the Committee to determine the further enhancements that may be necessary to address the remaining regulatory gaps, enhance enforcement and restore consumer confidence in the integrity of the price discovery mechanism.

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. Without giving the government the tools to detect and deter manipulation, market users and consumers of natural gas who depend on the integrity of the natural gas market cannot have the confidence in those markets that the public deserves. We believe that the Treasury Proposal provides this Committee with a very good foundation for achieving those goals.

Biography for Dave Schryver

Dave Schryver became the Executive Vice President of the American Public Gas Association (APGA) in August of 2006. He joined as Vice President for Congressional Affairs in February, 2004. In this position, he is responsible for coordinating and implementing legislative and regulatory advocacy efforts for the association. APGA is the national association of publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states. Publicly-owned gas systems are not-for-profit retail distribution entities that are 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.

Prior to joining APGA Dave worked for the American Public Power Association as a Senior Government Relations Representative. While at APPA, Dave worked on comprehensive energy legislation and served as liaison to the APPA Policy Makers Council, a group of locally-elected and appointed officials that advocate on behalf of public power.

Dave also served as Manager of the Government Affairs Department for Colorado Springs Utilities (CSU), a four-service municipally-owned utility. In this position, he oversaw CSU's legislative advocacy efforts at both the federal and state level. He also served on the Board of Directors for the Colorado Water Congress and the National Water Resources Association. Prior to joining CSU, he worked on Capitol Hill for seven years for Senator John Breaux from Louisiana. In 2008 Dave earned the Certified Association Executive (CAE) credential from the American Society of Association Executives (ASAE). In 2009 he completed the 4-year Institute of Organization Management (IOM), a four-year nonprofit leadership training program. Dave holds a Bachelor of Arts degree from Miami University in Oxford, Ohio.

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, 2006.

Name: David Schryver
Address: 201 Massachusetts Avenue, NE, Suite C-4
Telephone: 202-464-2742
Organization you represent (if any): American Public Gas Association

1. Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2006, 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, 2006, as well as the source and the amount of each grant or contract:

Source: U.S. Dept. of Transportation / PHMSA Amount: \$1,463,526

Source: _____ Amount: _____

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

Signature: Paul Schryver

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