

TESTIMONY OF
THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA
BEFORE
THE
HOUSE COMMITTEE ON AGRICULTURE
SEPTEMBER 17 AND 22, 2009

Independent producers drill about 90 percent of American natural gas and oil wells, accounting for more than 80 percent of American natural gas and more than 65 percent of American oil. The Independent Petroleum Association of America (“IPAA”) represents these thousands of independent producers. Many of these producers hedge their production to lessen the volatility in prices to better plan their budgets for finding and producing oil and natural gas, and in turn keep employment levels stable or growing. As end users in the derivatives market, independent producers strongly support increased transparency and encourage adequate funding and authority for the Commodity Futures Trading Commission to oversee commodity markets and prevent market manipulation.

However, increased transparency and stronger enforcement do not require that all trading be done through regulated exchanges. When producers hedge, they tend to rely on the over-the-counter (“OTC”) market, which enables hedging transactions to be customized, primarily to rely on the producers' natural gas and oil reserves as collateral or the producer's credit standing with its bank. Banks with loans to producers often require producers to hedge their production. The banks often perform this service for the producer, using the producers' natural gas and oil reserves as collateral.

The Treasury Department's financial reform proposal recognizes the continued importance of the OTC market. Secretary Geithner has testified that “[d]estroying OTC derivatives would leave U.S. companies

with a terrible choice between either not protecting themselves at all against some of their financial risks or partially protecting themselves against financial risk with a standardized derivative and thereby damaging their financial statement.” IPAA is in complete agreement with the Secretary’s assessment and with the intent to distinguish between end users and derivative dealers or major market participants.

Without access to the OTC market, producers would have two choices. Producers could attempt to monetize their assets and hedge through an exchange, which would consume cash previously reinvested in exploration and production. Or producers simply would be unable to afford the exchange hedging requirements and would not hedge. This choice would subject producers to pricing uncertainty and the ensuing uncertainty to producers' budgets for exploration, production, and employee salaries.

How and Why Producers Hedge

Many energy producers, who own the underlying physical commodities, use hedging as a primary risk-management tool to provide cash-flow certainty. These energy producers were not responsible for the recent swings in futures prices. In 2000, about 17 percent of independent producers used swaps to manage financial risk. That percentage increased dramatically to 41.5 percent in 2007, based on a recent IPAA survey, as detailed in its *Profile of Independent Producers 2009*.

Many independent producers hedge a significant portion of forecasted future natural gas and oil production volumes to reduce revenue risk related to ever-changing commodity prices. Wild swings in natural gas and oil prices impede the industry’s ability to stabilize revenues and prudently manage cash flow, which is used to fund development activities that produce vital energy resources and maximize value for stakeholders. For many independent producers, hedging is the primary method of ensuring that adequate cash flow is available to meet their financial obligations. They also hedge production to provide security to lenders that base producers’ credit on the value of their natural gas and oil reserves, reserves that are pledged as collateral on bank loans. Conscientious hedging programs provide significant

protection for creditors. This protection, in turn, helps provide access to capital for the long-term survival of producers.

Impact of the Proposed Reforms on Producers

The Administration's proposal appears to try to address the concerns described above. However, the push for standardized contracts to trade exclusively through regulated exchanges creates enormous uncertainty as to what will constitute a standardized contract. Equally important is the definition of major swap participant. The Administration's proposed definition of "major swap participant" includes anyone who (1) is not a swap dealer, (2) maintains a "substantial" net position in outstanding derivative contracts, and (3) is not using the contracts to maintain an effective hedge under Generally Accepted Accounting Principles. Uncertainties associated with the second and third components of the definition are likely to undermine the deference the Administration appeared to give to end users. A more clear-cut exemption approach is needed.

Failure to address this uncertainty could require producers to trade on a regulated exchange where the contrast is stark with current hedging methods. Currently, many independent producers hedge exclusively with the high-credit quality banks that are participants in their lending groups and hold the mortgages on their natural gas and oil properties. This arrangement eliminates the need for posting collateral between the producers and their banks. Producers enter into hedges and their banks hold those positions on their books through settlement, at which time either producers make a payment to the banks, or banks make a payment to producers, and the position is terminated. Under a broad interpretation of "standardized derivative contract" or "major swap participant," producers could be prohibited from hedging with their banks and forced to trade directly with the exchanges, which would require producers to post cash collateral twice daily, based on the mark-to-market value of their hedges.

The requirement to post collateral would effectively preclude the ability of many independent producers to hedge production and would imperil their business in many ways, leading to the destruction of relationships with stakeholders and harming the American consumers who depend on natural gas and oil products for food, shelter, transportation, medicine and other essentials of modern life. The inability to hedge would reduce the certainty in producers' ability to forecast cash flow to cover obligations to debt and equity holders, including debt service and dividend payments, respectively.

Furthermore, without the assurance of receiving a certain price for future production, creditors would lower their valuation of natural gas and oil reserves and reduce the amount of capital available to develop production and maintain, as well as increase, production volumes to meet consumer demand. Without development activities, natural gas and oil production volumes would decline, in some cases very rapidly – leading to a supply shortage in the market. The resulting spike in energy costs would have a decidedly negative impact on the American economy.

The Treasury Department's proposal is encouraging, in that the scope appears to address the importance of maintaining end users' access to the OTC market. The details will determine whether this intent is actually accomplished. We thank the Administration and the members of the Agriculture Committee for their thoughtful consideration of how to implement reform without serious unintended consequences.

Natural gas and oil are both vital components of our nation's energy supply. In fact, as a resource that is clean burning, readily available and abundant in America, it would make sense for natural gas to be adopted as a major component of the Administration's energy policy. America's independent producers reinvest a majority of their free cash flow to supply the country with reliable energy that is vital to our nation's energy security. Hedging through the OTC market helps producers reduce risk and plan for long-term viability in a highly capital-intensive business that depends on predictable cash flow and access to capital.

Suggested Treatment of End Users

At the September 17, 2009 hearing, Committee members engaged panel members to provide suggested language to clarify the exemption from mandatory clearing in the Treasury Proposal. In response, the American Public Gas Association (“APGA”) submitted a letter to the Committee on September 30, 2009. APGA suggested inclusion of an additional exception, in which mandatory clearing would not apply if “one of the counterparties to the swap is a producer, processor, merchandiser, distributor or a manufacturer of, or user of, a commodity and enters the swap to reduce or manage risks in connection with the conduct or management of its commercial enterprise.”

IPAA believes that this type of approach could address some of the end users’ concerns with efforts to encourage mandatory clearing, such as those contained in Treasury’s proposal. IPAA will be giving consideration to this proposal within its membership, and encourages the Committee to take APGA’s proposal under serious review.