

Legitimate Hedging Now Under Fire

May 29, 2009



Dear IPAA Members and Colleagues:

Congress is returning to business next week after a week-long Memorial Day recess. And some of the issues they will be tackling will directly affect domestic oil and natural gas production – and not for the better.

One of the largest issues receiving attention in Washington is the Waxman-Markey Energy-Climate Bill. On May 22, the House Committee on Energy and Commerce reported H.R. 2454, "The American Clean Energy and Security Act". Typically called the Waxman-Markey bill, it includes provisions on various energy issues, such as a Renewable Electricity Standard and creates a cap-and-trade global climate program.

Hedging. For producers, the most threatening portion of the bill may be new commodity market provisions that affect hedging. It imposes sweeping changes on the ways producers hedge their production. Shortly before committee mark-up, Rep. Bart Stupak (D-MI) introduced a bill, similar to legislation introduced in the previous Congress that would require the clearing of over-the-counter (OTC) derivatives across all asset classes, including commodities, foreign exchange, and interest rates. In return for Stupak's support of the Waxman-Markey bill, Chairman Henry Waxman (D-CA) added Stupak's bill into a chairman's substitute for the original bill as markup began.

As the bill was reported, IPAA identified that these market provisions posed a significant threat to producers' hedging options and IPAA is now reaching to other hedging interests, such as consumers, to develop opposition to the OTC provisions. Whereas OTC derivatives are highly customized to manage specific risks, the adopted Stupak language would prohibit hedge customization and impose cash or cash-equivalent collateral. Under customization, the process of qualifying for "hedge accounting" under U.S. accounting rules is simplified. With clearing, the availability of hedge accounting may be reduced, which could result in significant volatility swings in earnings. The requirement for cash or cash-equivalent collateral would be an enormous liquidity and operational burden. This provision will likely draw consideration by both the Committee on Agriculture, which has reported a commodity markets bill, and the Committee on Financial Services because of overlapping jurisdiction.

Greenhouse Gas Emissions. Most of the public focus on the Waxman-Markey bill relates to the creation of a cap-and-trade program to reduce U.S. greenhouse gas (GHG) emissions. The global climate title places limits on emissions of GHG. This legislation would cut GHG by 17% compared to 2005 levels in 2020, by 42% in 2030, and by 83% in 2050. Its future success hinges on the development of commercially available and widely accessible carbon capture and sequestration technology. The bill was reported by the committee on a 33-25 vote – essentially a party line vote with one Republican voting for the bill and four Democrats voting against.

Continued on back...

It is a product of extensive negotiations to achieve the narrow majority needed to pass it. As such, it defers to coal state interests more than natural gas. But, unlike the Senate legislation of the 110th Congress, it places the point of regulation on emissions sources exceeding 25,000 tons/year of equivalent carbon dioxide emissions. There are other issues in the global climate portion of the bill that need to be addressed, but the point of regulation has been an important issue of U.S. natural gas producers. IPAA had strongly opposed the earlier Senate bill because it required gas processors to acquire the GHG emissions rights for natural gas – an approach that would likely have caused the burden to shift to producers. The H.R. 2454 point of regulation does not create this risk.

Hydraulic Fracturing. As the Energy and Commerce Committee began to move toward markup, Rep. Diana DeGette (D-CO) publicly discussed the possibility of offering a hydraulic fracturing amendment to the bill. IPAA coordinated a broad response opposing an amendment with other trade associations and member companies. DeGette eventually backed away from addressing the issue in the bill but indicated that she intended to introduce a bill in the near future.

Next Steps. The House Ways and Means Committee will review the legislation, too. It may address the cap-and-trade process and it may create an energy tax title. Oil and natural gas tax policy could be a part of any energy tax title. IPAA's active opposition to the Obama Administration oil and natural gas tax proposals have set the stage to oppose adverse provisions in an energy tax title. Such a title will likely consider tax increases to offset any new tax benefits that are created. The amount of the tax benefits will determine which producer tax provisions are at risk. IPAA will continue its aggressive efforts to garner broad opposition to these adverse tax proposals. Similarly, the Committee on Natural Resources may create a title on federal resource oil and natural gas development both onshore and offshore. IPAA anticipates that the "use it or lose it" issue will be raised again in some format with greater restrictions on leases.

IPAA will be following the negotiations and advocating changes to protect American production. As additional information becomes available, IPAA will provide updates.

Thank you for your support,



Barry Russell
IPAA President and CEO