America's Oil & Gas Producers

July 29, 2008

The Honorable Nancy Pelosi
Speaker
Unites States House of Representatives
Washington, D. C. 20515

Dear Madame Speaker:

This letter is submitted on behalf of America's independent producers. With speculation in the energy markets a focal point of Congressional attention, Congress must not enact legislation that injures oil and natural gas producers and consumers hedging in the market to stabilize their costs and capital flow. America's independent producers rely on hedges to create predictable cash flows. In many cases these hedged cash flows are the basis on which producers are able to borrow funds to acquire and develop new American resources; in other cases it provides a company with a predictable cash flow to carry out its development plans.

Most independent producers do not have resident capability to participate in the futures markets directly. Moreover, in many instances the futures markets do not offer the type of product that meets the requirements of producers. Consequently, producers seek competitive quotes from financial intermediaries to hedge those risks in a customized manner. Legislative action that would prevent or diminish independent producers' access to hedging adversely affects their ability to develop new American production. Since independent producers develop about 90 percent of wells in the United States, produce over 80 percent of its natural gas and produce over 65 percent of its petroleum, creating barriers to obtaining the capital necessary for these efforts harms the nation's energy supply. Moreover, America's independent producers have a history of investing in excess of their cash flow from American projects back into new American producers. Consequently, diminishing this investment has even larger implications.

H.R. 6604, the "Commodity Markets Transparency and Accountability Act of 2008", contains a number of provisions which will provide more transparency to the commodities markets so that regulators and policymakers can determine the role of speculation in the markets and whether there is excess speculation contributing to higher energy prices. We do not object to these provisions. Our primary concern relates to Section 8, entitled "Trading Limits to Prevent Excessive Speculation", which creates a structure to separate "bona fide hedging" from other trading. This section essentially defines "bona fide" hedging transactions as those entered into by producers/consumers of energy or agricultural commodities. However, it fails to recognize that financial intermediaries rely on trades that they do with other parties, including other dealers and market participants, to enable the financial intermediaries to manage the risks they assuming in their hedging commitments with producers. This constraint is inconsistent with how financial intermediaries manage risk internally so that they can offer competitive and effective hedging transactions to energy producers.

How financial intermediaries offset the risk they assume from producers and consumers of commodities. Financial intermediaries have three avenues available for hedging their risks – risks they take on from numerous clients and through thousands of contracts. Beginning with the most efficient and cost effective, they are: (1) by internally matching up their exposures across their global portfolio of contracts to determine the residual exposure based on the aggregate, (2) by matching up offsetting liabilities with other intermediaries contractually, and (3) by going to the futures market and buying futures contracts. This process is a dynamic and ongoing process as liabilities and the portfolios shift every day. It is a key part of the risk management system for financial intermediaries. It is a multi-dimensional process – the risk arising from each client contract is not managed separately but as part of a portfolio. This risk management system allows financial intermediaries to provide hedging opportunities to clients in the most efficient and cost effective manner.

The intermediary enters into thousands of transactions with clients, all for varying terms on a range of products -- from twenty types of crude oil with twenty different delivery points, to electricity, to jet fuel. Daily, the intermediary looks at its "book" or portfolio of risk that it has assumed worldwide and "nets out" its exposure. For example, it may have agreed contractually to cover the cost of 600,000 barrels of crude oil at the end of 2012 for a number of oil consuming clients at a fixed price and to provide payment for 400,000 barrels of the same crude oil to a number of oil producing clients in the same time frame. In this simplistic example, the intermediary still has an obligation related to 200,000 barrels of crude oil that it will have to offset by other means. The intermediary performs this process across its entire portfolio, matching up offsetting liabilities to determine its residual risks in a range of commodities.

This process is based on the economies of scale which the intermediary can offer its clients by managing its own portfolio on an aggregate basis. Just as an individual ends up with a balance in his or her checkbook at the end of the month after netting out the difference between paychecks deposited and bills paid, the intermediary determines what residual risk needs to be offset. Section 8 would essentially require the intermediary to establish and maintain a separate "checking account" for each "bona fide" hedger counterparty. Such an approach would be an inefficient and ineffective system.

Constrained ability of intermediary to offset risk assumed from bona fide hedger. Under the proposed legislation, hedging through an intermediary will cost more, by managing the risk assumed from each client transaction separately. Further, producers will have more difficulty getting financing for infrastructure development because they will not be able to hedge in a manner consistent with the duration of the loans they need. Third, intermediaries may decide that it is too cumbersome and expensive to provide hedging and no longer offer that service in the U.S., leaving producers with no avenue for obtaining customized hedges.

Before the House acts on H. R. 6604, these failures in the structure of Section 8 need to be addressed and resolved to assure that independent producers are able to continue their current hedging activities with the same scope and flexibility that now exists.

Sincerely,

Barry Russell
President and CEO