HOUSTON
BUSINESS JOURNAL
Strictly Houston. Strictly Business.

Week of October 8-14, 2010

'Dodd-Frank' is next storm to weather for energy companies

BY PAUL TURNER, JACOB DWECK AND CHRISTOPHER DELPHIN
SPECIAL TO HOUSTON BUSINESS JOURNAL

When Congress set out to ensure that AIG-style government bailouts never happen again, it produced a pervasive law that will fundamentally change the way the energy industry conducts business.

Oil producers, midstream companies, utilities and others that have long relied on "over-the-counter" swaps to protect against market price volatility now must rethink their entire approach, dedicate more precious capital to hedging — and prepare to comply with a myriad of new regulations expected to be spewed in coming months by federal regulators at the Commodity Futures Trading Commission.

Be prepared they must, as there is no turning back the legislative clock. Each company, to best manage price risks survival, will need to analyze the likely impact of Dodd-Frank (Wall Street Reform and Consumer Protection Act) on its business and develop contingency coping plans, depending on how the regulators address critical questions that Congress left to their discretion.

For most businesses, the impact and planning begins by sorting out the answers to certain key questions:

How much more would it cost me to hedge?

What swaps would have to be "cleared" through regulated exchanges?

How would the law treat my collateral or structured derivatives used to finance my business?

How will the law treat my counterparties, banks, dealers and others willing to assume the other side of my hedge risk?

And so on.

Most traditional energy companies likely will be treated as "end-users" under Dodd-Frank. While at first glance a seemingly "protected" class of businesses, in fact such protection may prove illusory and the actual impact of the law on end-users could be quite severe. By seeking to rein in the excess of Wall Street, Congress managed to ensnarl the "Main Street" of the oil and gas industry.

CLEARING THE WAY TO 'CLEAR'

Seeking to avoid forever the shadowy world of credit default swaps, Dodd-Frank imposes rules and creates strong biases to push as many over-the-counter derivatives onto regulated clearing exchanges to create transparency and spread the risk of default, similar to how futures energy contracts are currently cleared in NYMEX. But this means that energy end-users and other clearing parties would have to post

cash "margin" to support their hedges, expected to be far in excess of what they currently post for over-the-counter derivatives. This will include "initial" margin posted as security regardless of how the market moves, and "variation" margin posted as the price of the underlying commodity fluctuates.

One notable example of the inefficiency of the clearing requirement involves the current practice by some producers of entering into a hedge with the purchaser of their physical product. In this way, when the market price moves, the exposure under the physical contract and the financial contract fluctuate in opposite directions, thus reducing the collateral posting requirements through exposure netting. If the swap is required to be cleared, however, the party to the physical contract no longer is the same entity with whom the financial contract has been entered — and the benefits of exposure netting would be lost.

Clearing may work for generally standardized swaps. It would be impossible to clear derivatives with individualized features, for example, long-term structured deals used to finance an energy business.

By seeking to rein in the excess of Wall Street, Congress managed to ensnarl the 'Main Street' of the oil and gas industry.

The treatment of swaps falling in between the standardized and the structured promises to cause years of headaches for regulators and the industry alike.

EXEMPTION: REALITY OR ILLUSION

End-users seeking solace in exemption of their true hedges from the clearing requirement soon discover such exemption may not extend to newly imposed margin and capital requirements for "uncleared" swaps.

For the exemption to work, it would have to apply not only to the energy end-user's hedge, but also to the "upstream" hedge entered into by its counterparty bank, dealer or other financial entity. If the seller of the swap is required to post margin or maintain capital for the upstream hedge, such seller is likely to pass on its costs to the end-user, in the form of collateral or higher price.

In short, end-users accustomed to receiving credit for their hedges from a financial counterparty likely will be required under Dodd-Frank to have greater resources to pay for or collateralize their swaps. This could well change the way some energy companies currently manage commodity price risks.

COSTS, COMPLICATIONS AND MORE COSTS

Thankfully, the law allows end-users to post noncash collateral in support of uncleared swaps, recognizing the significant burden of requiring cash collateral. Energy end-users can post letters of credit, bonds, or even security interests in their production as credit support. As the rules unfold, many will follow closely what types of other noncash collateral will be acceptable for uncleared swaps. Still, end-users should expect higher costs because such credit support could not be easily converted to meet the seller's margin posting requirements for its upstream hedge.

The law embeds many other costs and untold complications. As large financial players in derivatives will face more pervasive, bank-like regulation and registration, capital and reporting requirements, they undoubtedly will pass the associated, additional costs along to the end-users. Higher costs also can be incurred in the form of increased collateral requirements and costs for physical transactions.

The impact of Dodd-Frank will vary from one energy company to the next, depending on how they employ swaps in their business. But what does not vary is the essential wisdom of having each company carefully analyze the law and likely regulations, and adopt effective plans to deal with what the law has dished out. ■

PAUL TURNER is a partner in the Houston energy and environmental practice group and **JACOB DWECK** is a partner in the Washington, D.C., energy and environmental practice group of Sutherland Asbill & Brennan LLP. **CHRISTOPHER DELPHIN,** an associate in the Houston energy and environmental practice group of Sutherland Asbill & Brennan, contributed to this commentary.

Reprinted for web use with permission from the ***Houston Business Journal***. ©2010, all rights reserved. Reprinted by Scoop ReprintSource 1-800-767-3263.