Coalition of Physical Energy Companies (COPE)

Meeting with Commodity Futures Trading Commission Staff

Friday, November 12, 2010

COPE Members

- COPE is a broad and diverse group of companies engaged in various aspects of the physical energy business, including
  - Oil and natural gas production
  - Electricity generation
  - Retail natural gas and electricity sales
  - Midstream natural gas, oil and petroleum products transactions
- Members hedge commodity price volatility with OTC swaps

Hedging For Risk Management

- COPE members utilize swaps to manage price risk associated with physical commodities that they produce, buy and sell, such as oil, natural gas and power
- COPE members are 'end-users' of swaps -- not 'swap dealers' as that term is used in Dodd-Frank
- COPE members use swaps for risk management, not speculation

Unsecured Credit and Non-Cash Collateral

- Unsecured credit and/or non-cash collateral is utilized by COPE members to support hedging physical commodity price risk through OTC swaps
- COPE members are able to obtain unsecured credit due to the strong financial standing of their physical businesses, many with conservative balance sheets and investment grade credit ratings
- Some members' exposures may also be collateralized by first liens on company assets
- Reduction in the availability of prudently extended unsecured credit or limitations on non-cash collateral would impact the ability to hedge and divert capital from productive uses

Impact of Elimination/Reduction of Unsecured Credit & Non-Cash Collateral

- Reduce Hedging/Risk Management
  - increase business risk
  - Increase revenue/earnings volatility
  - Increase liquidity/financial risks
- Significantly increase collateral posting to banks
- Divert Capital from Productive Uses:
  - Divert capital from energy production, exploration, environmental infrastructure investment & innovation
  - Increase the cost of doing business impacting commodity prices
  - Increase costs to consumers

COPE Members: Profiles

Apache Corporation

- Global independent exploration and production company
- $39.75 B market capitalization / investment grade credit rating
- 634,000 BOE day of production, 2.4 billion BOE reserves
- Extensive worldwide exploration acreage and project inventory
- Apache conducts commodity hedging as part of Apache's risk management activities
  - Apache does not post collateral or margin nor pledge assets
  - No proprietary or speculative trading
  - No Futures Commission Merchant (FCM) accounts
  - Apache does not make a market in derivatives with our physical commodity counterparties

Noble Energy, Inc.

- Global Independent Exploration and Production Company
- $13.5 B Market Capitalization / Investment Grade Credit Rating
- 230,000 BOE Day of Production, 820 Million BOE Reserves
- World's Largest Conventional Gas Discovery in 2009 - Israel Offshore - Tamar Project
- Extensive Worldwide Exploration Acreage and Project Inventory
- Noble Conducts Commodity Hedging as Part of its Treasury / Risk Management Activities
  - NBL Does Not Post Collateral or Margin nor Pledge Assets
  - No Proprietary Trading
  - No Hedging with Futures
  - No Derivatives Offered to Physical Customers
  - All Information on Hedge Program is Publicly Disclosed

Apache Corporation and Noble Energy, Inc.

- Conduct Commodity Hedging to
  - Reduce Commodity Price Volatility Exposure
  - Enhance Predictability of Cash Flow and Earnings
  - Secure Acquisition and Major Project Economics

<u>Requirements to Operate Effectively</u>

- Unambiguous Designation as "Exempt End-User"
- Retain No Collateral or Margin Requirements
- No Position Limits for Hedges

MarkWest Energy Partners, L.P.

- Publically traded partnership (US: MWE), $3B market cap, 600 Employees in 9 states
- Provides midstream services to natural gas producers
  - Owns and operates critical pipeline and plant infrastructure between wellhead and consumer
  - Significant ongoing investment in energy infrastructure ($1.5B in 2008-2010)
- Approximately 80 similar peer companies in United States $0.5B-$22B Market cap
- Publicly traded partnerships distribute essentially all cash flow to share holders on a quarterly basis
- Share holders tend to be conservative investors seeking a secure annuity with low share price volatility risk
- Midstream cash flows have varying volatility with commodity prices
  - Long natural gas liquids/crude oil
  - Short natural gas (keep whole contracts, fuel)
- MWE hedges its physical commodity positions to minimize cash flow volatility and secure future distributions to share holders (not to speculate)

MarkWest Energy Partners, L.P.

- MWE is an "End-User" and executes OTC swaps, collars and puts with secured lenders in its bank group
  - Secured lenders are the swap counterparty for MWE
  - Secured lenders are secured by all of MWE's assets (over $4B) and contracts
  - Contracts grant security interests in physical commodities including natural gas liquids, crude condensate and natural gas
  - No cash margins are required due to the significant non-cash collateral and title to the physical commodity itself
- In a volatile commodity market, Mark-to-Market positions can be very large either in or out of the money (sometimes hundreds of millions of dollars for a company like MWE)
- Imposition of cash margin posting would be disastrous for companies like MWE who make major capital investments and distribute essentially all of their cash flow each quarter to share holders
  - The capital would have to be held idle and liquid at all times to avoid default putting distributions and expansion capital spending at risk
  - Our customers, natural gas producers, would have the same issue and they would be less able to drill gas wells to fill our pipelines and plants

El Paso Corporation

- Purpose is to provide natural gas and related energy products in a safe, efficient, and dependable manner
- Organized around two core businesses—Pipelines and Exploration & Production
- Owns North America's largest interstate natural gas pipeline system—approximately 42,000 miles—transporting more than a quarter of the natural gas consumed in the country each day
- E&P operation ranks in the top 10 domestic independent producers, operating in high-quality basins across the United States and in Brazil and Egypt
- E&P oil opportunities are expanding with success in the Eagle Ford shale and a 135,000 net acre position in the Wolfcamp oil shale; Ruby Pipeline has construction activity underway in all eight spreads along its 680-mile route

El Paso Corporation

- El Paso conducts its hedging activity through an asset-backed credit facility that allows over-the-counter transactions without cash margin requirements
  - El Paso's physical assets serve as collateral support for its financial hedge transactions
  - The credit facility includes a diverse group of bank trading counterparties among which risk is distributed
  - El Paso does not conduct any proprietary, speculative trading of energy derivatives

- El Paso hedges its commodity price exposure to:
  - Gain a level of certainty around cash flows and earnings
  - Ensure cash is available for investment in new production programs, planned Capex projects, and/or acquisitions

El Paso Corporation

- Forced clearing of hedge transactions on an exchange that requires cash margining would:
  - Create a huge cash margining burden on prudent producers who hedge their physical production
  - Restrict investment at precisely the time the market most needs it: when commodity prices are high
  - Limit producers' ability to effectively and efficiently reduce commodity price volatility

Competitive Power Ventures, Inc.

- Leading North American electric power generation development and asset management company
- $0.3 B Private Equity funding provided by Warburg Pincus
- Over 10,000 MW of natural gas and wind generation assets currently in various stages of development with plans for more
- Third-party manager for more than 4,400 MW of North American merchant gas-fired assets
- CPV has supplied commodity hedging services as part of the Risk Management activities for those project companies under management as well as its own development portfolio
  - No Proprietary Trading permitted under Credit Agreements
  - Project companies post a Letter of Credit or provide 1st Lien collateral support for all hedging transactions
  - Commodity hedging is a secured transaction; often over-secured

Competitive Power Ventures, Inc.

- Commodity Hedging is conducted primarily to:
  - Reduce Commodity Price Volatility Exposure
  - Ensure Predictability of Cash Flow and Earnings
  - Secure Financings and Major Project Economics
- Commodity Hedging is an essential business practice to bring new generation resources to market
- Providing a 1st Lien position as collateral support permits
  - Value of collateral moving in conjunction with value of underlying asset (right-way risk)
  - In event of default, counterparty has claim in an amount determined according to mark-to-market of hedge as negotiated

<u>Requirements to Operate Effectively</u>

- Unambiguous Designation as "Exempt End-User"
- Retain Asset-Based and Non-Cash Collateral for Swaps
- No Position Limits for Hedges

Iberdrola Renewables, Inc.

- Diverse energy company
  - Portland, Oregon based (850 employees)
- Renewable energy
  - Second largest U.S. wind energy generator
  - Solar and biomass
- Gas-fired electricity generation
- Gas storage
  - 155 BCF owned and contracted
- Energy trading

Iberdrola Renewables, Inc.

- Uses trading activities to hedge its physical exposure in wind and storage businesses
  - Manages exposures through dynamic trading
- Sells energy products and services to electric and gas distribution utilities, industrial customers and financial institutions
- Industry concentrations have the potential to impact our overall exposure to credit risk, either positively or negatively, because the customer base may be similarly affected by economic, weather or other conditions

Iberdrola Renewables, Inc.

- Iberdrola Renewables faces a number of energy market risk exposures including fixed price, basis (both location and time) and heat rate risk
- Contracted gas storage exposures are impacted by gas price differentials across time
  - This exposure is managed with fixed price, basis and index gas derivatives
- Contracted transport positions are subject to gas price risk across location, price differential between receipt and delivery points
  - This exposure is managed with basis swaps
- Merchant power plants are subject to heat rate risk
  - This exposure is managed with fixed price electricity and fixed price gas and basis positions
- Merchant wind facilities are subject to fixed price power risk
  - This exposure is managed with fixed price electricity

Shell (SENA and STUSCO)

- Shell Energy North America and Shell Trading (US) Company are the North American component of the Shell Trading network, a global business engaged in trading and shipping activities on behalf of Shell. Headquartered in Houston but with regional offices throughout the United States and Canada, the companies' combined portfolios of commodities include natural gas, power, crude oil, refined products, chemical feedstocks and environmental products.

Shell (SENA and STUSCO)

- SENA trades and markets natural gas, wholesale power and environmental products.
- Customers include large commercial and industrial users, local gas distribution companies, electric utilities, independent power producers, energy aggregators, and oil and gas producers.
    - Natural gas: Sales volumes of 15.1 billion cubic feet/day (Q2 2010)
    - Wholesale power: Sales volumes of over 220 Million MWh (2009)
    - Participates in nearly all organised North American power markets
    - 5,000 megawatts of generating capacity across North America
- STUSCO trades and markets domestic crude oil and products; crude oil lease acquisition, marketing and transport; marine chartering.
    - Buys and sells more than 7 million barrels/day of hydrocarbons
    - One of the largest physical traders of hydrocarbons in the United States
    - Manages more than 400 international voyages per year
    - Schedules more than 4,000 domestic shipping voyages per year
- SENA & STUSCO utilize swaps and futures to hedge risks of their physical businesses
- Due to strong credit standing, SENA & STUSCO are provided levels of unsecured credit by their swap counterparties

Retail Energy Providers

- Retail energy providers that sell to retail consumers utilize swaps to hedge price risk (e.g., fixed priced offers)
  - The retail consumers can be residential, commercial or industrial consumers
- Trade credit is earned by the retail energy providers
  - Counterparties conduct thorough financial diligence and creditworthiness evaluation
  - Trade credit is monitored regularly and adjusted based on company performance and creditworthiness
- Currently, retail energy providers are able to utilize trade credit when purchasing these swaps
  - This reduces the risk of having to post additional collateral due to changes in the commodity market
- If retail energy providers no longer have access to trade credit there will be additional risk / cost for these types of fixed price products
  - The risk / cost will be having to post additional capital
  - This potential cost will result in increased prices to consumers due to:
    - The need to recover the cost of incremental capital requirements, or
    - A reduction in retail energy providers offering these types of products thereby reducing the benefits of competition