The Camp Discussion Draft of Financial Products Reform

HW&M Chairman Camp's "Discussion Draft of Financial Products Reform" (the Draft) raises some concerns for the natural gas and utility industries. Rather than achieve the goal of simplification, some of the provisions tend to increase complexity in an already highly complex area of the federal law. Indeed, some of the provisions, left unaltered, could require steep increases in compliance costs. The gas and utility industries rely on both the low cost of capital and their liquidity positions to continue to invest heavily in our nation's energy infrastructure and to continue to create U.S. jobs. The Draft presently tends to weaken the financial liquidity position of our industries, raises concerns about our abilities to carry out our capital investment strategies, and increases volatility in the rates we must charge to our customers. The significant issues affecting our industries (as well as all businesses involved in risk management transactions) include the following:

1. The Draft acknowledges the need to exclude hedging transactions from the reform proposals. Such an exemption, that unambiguously permits legitimate risk management transactions to qualify as tax hedges, must be part of the tax treatment of financial products. Otherwise, the current tax hedging definition will not solve the problem of regulatory uncertainty. Without modernization of the hedging definition many legitimate risk management transactions will be inappropriately swept into the anti-abuse proposals.

> Accordingly, we urge Congress to clarify the current definition of hedging. We also urge Congress to define tax hedges as derivative transactions entered into by a taxpayer in its trade or business to manage its business [or investment] risks, and that such tax hedges be exempt from the reform provisions under discussion. Tax hedges are subject to clear reflection of income (for Code § 1221(a)(7) hedges) or tax integration (for Code § 988(d) hedges and Treas. Reg. § 1.1275-6 hedges).

a. Common risk management practices should be defined broadly to include all risk management products entered into the ordinary course of a taxpayer's trade or business to manage its risks, including changes in interest rates, commodity prices, volume and revenue, weather risk, and currency.

b. Tax character should be ordinary because common risk management transactions are entered into in the ordinary course of the taxpayer's trade or business. Otherwise, capital characterization could result in the permanent disallowance of capital losses. Capital losses only offset capital gains and can only be carried forward or back to offset capital gains over the applicable carryover periods.

c. Gains and losses should be taken into account in accordance with the tax accounting rules for hedging transactions: that is, on a clear reflection income basis for Code § 1221(a)(7) hedges under Treas. Reg. § 1.446-4, and on an integrated basis for Code § 988(d) hedges under Treas. Reg. § 1.988. Mark to market tax is simply not necessary for transactions subject to these tax accounting hedges.

2. For the natural gas and utility industries, contracts and agreements that are commonly entered into the ordinary course of business can be marked to market for financial

accounting purposes under US GAAP rules and regulations. These contracts can qualify as tax hedges. We urge Congress to explicitly carve out from the definition of "derivative" such agreements and contracts (including tolling agreements, retail electric contracts, capacity contracts, power purchase agreements, TCCs, CRRs, FTRs, transmission agreements, collateral agreements, emission allowances, ancillary services, fuel supply contracts, and other agreements) entered into the ordinary course of business to produce, process, and deliver energy.

3. Defining as a "derivative" any evidence of an interest in any share or stock in a corporation, partnership or a trust is inappropriately broad. Many natural gas and utility companies have affiliates that are trusts, joint ventures, and MLPs. The inclusion of corporate, partnership and trust ownership interests in the broad definition of "derivative" would require these interests to be subject to an inappropriate mark to market regime. This would complicate compliance and unnecessarily increase costs. The determination of fair value is a highly complex proposition with steep compliance costs and administrative ramifications. We need simplification rather than complication here as well as throughout the reform measures.

4. The Draft provides that it intends to "simplify the business hedging rules" but the proposal seems to fall short of meaningful simplification. The Draft would allow taxpayers to meet their tax hedge identification requirement by relying on the hedge identifications they made for financial accounting purposes. While this proposal would provide some relief for inadvertently failing to qualify for tax hedging treatment by failing to make a same-day identification and we, therefore, welcome this proposal, the proposal falls short of modernizing or expanding the tax hedging rules.

5. Any legislative proposal should include transition rules and grandfather relief from potential tax character whipsaws that would be created when items that were capital assets now become ordinary assets, as well as for transactions previously not marked to market but now subject to mark-to-market.

6. The implications for embedded derivatives needs clarity for comment and would need to be addressed in any transition rules.