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SPECIALREPORT

Reform changes rules in derivatives market

Local companies that use hedging, such as American Airlines and Exxon, play a waiting game as regulations are drafted

BY CHAD ERIC WATT / STAFF WRITER

Changes to the derivatives market prompted by the Dodd-Frank financial reform bill will have an indirect impact on companies that use the securities as part of their business.

Most businesses, from big fuel purchasers to companies aiming to control foreign currency risks, aren't directly required to change practices, but the financial counterparties they work with are, said Jason Daniel, senior counsel in the Dallas office of law firm Akin Gump Strauss Hauer & Feld.

Generally, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, called the Wall Street Transparency and Accountability Act, aims to make derivatives more transparent. The bill signed into law July 21 has accomplished that, Daniel said. But to get there, the rules require more participants in these complex transactions. The result: "Transaction costs will increase," he said.

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Brandy King
Southwest Airlines

Many of the new rules governing hedging, derivatives and private contracts known as swaps are yet to be written. That work will fall to groups including the Commodity Futures Trading Commission and the Securities and Exchange Commission.

THE COST OF REFORM: Attorney Jason Daniel of Akin Gump Strauss Hauer & Feld says one aspect of financial reform aims to make reporting on derivatives use more transparent. The impact for companies that use hedging to reduce risk in commodity pricing or volatile foreign currency rates likely will be added costs, though specifics are unknown as regulations are still being drafted under the law.

DAVID PELLERIN

HEDGING: *Risks prompt some to halt use*

Given that murkiness, Dallas companies that use hedging as part of their business activities aren't too clear on how they'll be impacted.

"With this type of reform, we are mainly concerned with the unintended consequences of new legislation," said Southwest Airlines spokeswoman Brandy King in an e-mail.

Similarly, an American Airlines spokesman said it was too soon to tell what impact new and coming derivative rules would have on its business. American uses hedging in an attempt to dampen the impact of volatile fuel prices on its costs.

That's a good example of the business case for using derivatives, hedges and financial instruments generally called swaps, Daniel said. Airlines often aim to put a collar on the price they pay for jet fuel.

"They receive payments over that price to offset the economic impact of the price increase," he said.

Beyond airlines and other businesses that rely on commodities, companies that operate internationally will often use hedges to guard against currency fluctuations, Daniel said.

"There are various reasons to do it, one of which is just accounting certainty," Daniel said.

But hedging can also create big gains and losses for a company, independent of operating results.

In the second quarter of 2010, for example, Southwest recorded $146 million in "other losses" related mainly to unrealized losses in its hedging program. Overall, Southwest reported net income of $112 million for that quarter. The company recorded a $408 million loss on hedges for the full year of 2009 after a $1 billion hedging-related gain in 2008. (Overall, Southwest reported profits of $99 million in 2009 and $178 million in 2008.)

COURTESY PHOTO

RISKY BUSINESS: Warren Bonham, CEO of Euless-based Direct Fuels, opted against use of hedging. 'You have to be at a certain scale to do it and not allow it to create extra risk,' he says.

Derivative overkill?

That sort of volatility has some businesses large and small eschewing derivatives altogether.

Energy giant Exxon Mobil Corp. uses derivatives very sparingly. At the end of the second quarter, Exxon held $1 billion in derivatives, $995 million of which it acquired when it closed its purchase of XTO Energy in June. For context, Exxon had $291 billion in assets and $13.2 billion in cash or cash equivalents at the end of the second quarter. Exxon said in its second-quarter earnings report that it would discontinue the XTO derivative program once its current positions settle.

Euless-based Direct Fuels distributes gasoline and other fuels. Its revenues rise and fall with crude oil and gasoline prices, but the company sees too much risk in trying to hedge, said CEO Warren Bonham.

"You have to be at a certain scale to do it and not allow it to create extra risk," he said.

Direct Fuels had $277 million in revenue in 2009, down from $570.5 million in 2008, according to data supplied by the company. Much of that decline was tied to a drop in fuel prices.

Even if the company tried to hedge, the commodities securities available to it on the New York Mercantile Exchange don't precisely match real commodity prices for transactions in Dallas-Fort Worth.

"You can lose on the hedge transaction and on the physical transaction," he said.

DERIVATIVES RULE REDO

Requirements of the Wall Street Transparency and Accountability Act (Title VII of the broader reform bill):

- **IF A SWAP HAS BEEN ACCEPTED FOR CLEARING,** most swap counterparties will be required to clear those swaps through derivatives clearing organizations and will be subject to those organizations' margin requirements.
- **LARGE SWAP COUNTERPARTIES** will be subject to additional regulation, including capital and margin collection requirements.
- **ENTITIES THAT ARE USING SWAPS** to mitigate or hedge commercial risk are not required to clear their swaps as long as they are not a financial entity, such as a commodity pool, hedge fund or swap dealer, and have made a specified filing with the Commodity Futures Trading Commission.
- **SWAPS THAT ARE NOT REQUIRED** to be cleared must be reported to a swap data repository or the CFTC.
- **MANY SWAP POSITIONS** will now be included in speculative position limit.

Possible effects of the act

- **TRANSACTION COSTS**, especially with large swap counterparties, will likely increase to offset new regulatory requirements.
- **ONCE THE BILL TAKES EFFECT**, the prices and terms of swaps will become publicly available, which may decrease transaction prices.

Source: Attorney Jason Daniel of Akin Gump Strauss Hauer & Feld