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Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: *Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities*, RIN 7100–AE–10

Dear Mr. Frierson:

By an Advance Notice of Proposed Rulemaking ("ANOPR") issued on January 21, 2014,[1] the Board of Governors of the Federal Reserve System ("Board") has sought public comment on various issues related to physical commodity activities conducted by financial holding companies ("FHCs") subject to Board supervision. The focus of the Board's inquiry is physical commodity-related activities that have been found to be "complementary to a financial activity" under the banking laws, as well as certain grandfathered activities.[2]

The Coalition of Physical Energy Companies ("COPE")[3] appreciates the opportunity to provide comments to the Board on this important topic. The members of COPE are physical energy companies in the business of producing, processing, and merchandizing energy commodities at retail and wholesale. COPE members often transact physical commodity, financial commodity, and finance transactions with FHCs.

As physical energy companies that are active in multiple facets of energy commodity markets, COPE believes it can bring meaningful insight to the role and the value of FHCs in physical energy markets. COPE members interact with FHCs through both financial and physical transactions in such markets, as well as through financial services transactions.

[1] *Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities*, 79 Fed. Reg. 3329 (Jan. 21, 2014).

[2] ANOPR at 3329. *See*, Public Law No. 84-511, 70 Stat. 133 (1956), sec. 4(k)(1)(B).

[3] The members are: Apache Corporation; EP Energy LLC; Enterprise Products Partners, L.P.; Iberdrola Renewables, Inc.; Kinder Morgan; MarkWest Energy Partners, L.P.; Noble Energy, Inc.; Shell Energy North America (US), L.P.; SouthStar Energy Services LLC; and Targa Resources.

FHCs Play a Valuable Role in Physical Commodity Markets

COPE members value FHCs as counterparties for several reasons: (1) FHCs have strong balance sheets and are creditworthy counterparties that can soundly sustain significant and long-term transactions; (2) FHCs have strong compliance cultures and well-resourced support functions; (3) FHCs are supervised by regulators such as the Board; (4) FHCs possess sophisticated risk management abilities; (5) FHCs often have longstanding relationships with COPE members, including as lenders; and (6) there are benefits to physical commodity companies in undertaking transactions with FHCs that can span financial and physical activities. In addition to the counterparty benefits of FHCs, they are also important market makers in physical energy and related derivative markets and help provide market liquidity.

COPE members engage in a variety of physical energy commodity activities, including the production of electricity, natural gas, natural gas liquids, crude oil, and refined products, as well as sales, marketing, transportation, and processing. These activities take place in markets that have historically been subject to price volatility and may require significant capital investment. As a result, companies involved in such markets require counterparties to provide risk management services, purchase output, deliver product, and provide financing. Often these activities can be combined into a set of related transactions in which overall risk and credit issues can be effectively managed. At this time, only FHCs can perform this function.

For example, an FHC (or syndicate thereof) may combine these various activities into one transaction as a lender with a lien on the assets of an energy company. In addition to the lien securing the loan, it will also serve as security to physical offtake agreements and/or financial risk management services. This type of arrangement benefits both the physical company and the FHC.

The physical company can focus on its physical business with an offtake customer with strong credit paying a profitable price without having to divert cash to use for margin to cover commodity price volatility, which would be required if the lien structure did not exist. On the other hand, the FHC can ensure the integrity of its loan by purchasing the borrower's product at a price that covers the debt service, which it can also profitably market in commodity markets while using its risk management capabilities to limit downside risk. Thus, by the scope of capabilities the FHC can bring to the table, overall risk is reduced and efficiency is enhanced.

If the FHC could not perform the commodity-purchase aspect of the transaction, risk would be increased by the physical company being subject to volatile market prices or having to post cash collateral to a third party (with the potential of a counterparty default). Any of the foregoing could result in an increased risk of a physical company default on the loan and foreclosure by the FHC on the physical business subject to the lien (which it may be less capable of operating than an energy trading function).

The foregoing is only one very common example of the benefits to physical companies and FHCs of FHC participation in the physical energy commodity market. In addition, it is an example of a role no other party can play.

Below, COPE will briefly address other elements of FHC participation in physical markets that benefit physical companies.

<u>FHCs Are Creditworthy Counterparties</u>: Beyond their role as lenders, FHCs can enter into longer term contracts with physical companies. Given the volatility of energy markets, there is not a robust set of counterparties that have the financial wherewithal to enter into such transactions. Simply stated, there are few non-FHC physical counterparties that can perform long-term fixed price transactions.

Even without a loan, commodity sellers can offer a lien to support a long-term trade. FHCs can offer a strong balance sheet and possess sophisticated risk management skills to mitigate risk from the trade. The vast majority of other physical commodity intermediaries can offer neither.[4]

Without FHCs in the physical market there will be fewer long-term physical transactions due to the lesser creditworthiness of the remaining counterparties. The situation will be further exacerbated in the event that interest rates increase and further commodity price volatility occurs. The result will be increased exposure of physical companies to price volatility or the need to post significant cash collateral (which will need to be diverted from business needs or may not be available) to the derivatives clearing processes. This will lead to increased risks to physical companies by exposure to volatile markets or the need to post collateral they do not have to derivatives-clearing markets that do not recognize "right-way-risk" principles.[5]

<u>FHCs Have Strong Compliance Cultures and Well-Resourced Support Functions</u>: It is COPE's experience that FHCs have strong compliance cultures and execute well-documented, legally sound transactions. FHCs typically are knowledgeable about their customers/counterparties, understand and respect compliance, and employ capable legal, credit, and risk personnel.[6] As a result, physical companies doing business with FHCs can have a high level of confidence in the integrity of the transaction and the manner in which it will be carried out. As many physical companies are not traders and conduct a limited number of transactions, there is real comfort in engaging with a counterparty that is expert in such matters and is held to compliance standards by regulators such as the Board.

<u>FHCs Are Supervised by Regulators Such As the Board</u>: Physical companies understand that supervision by regulators such as the Board prevents FHCs from taking untoward risk and requires them to institute strong compliance programs and be well-capitalized. Further, FHCs are subject to periodic examinations to objectively verify that there are no deficiencies in the foregoing. Effectively, such supervision provides the closest thing to a "stamp of approval" that exists in today's world.[7]

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[4] However, in some cases, a commodity intermediary can offer a letter of credit – which is a way to indirectly draw an FHC back in to the physical deal.

[5] *See, e.g.*, Credit and Liquidity Risk Management: Better Practices for the Energy Industry, KPMG LLP. ("'Right-way-risk' relates to opportunities for outside parties to provide credit to a firm for short-term collateral needs due to market moves on derivative hedges with the knowledge that those same market moves are even more beneficial to the company's underlying business in the long run.")

[6] COPE is not impugning other counterparties with this observation but, rather, merely pointing out that by the nature of their businesses, FHCs are held to high standards and have the internal infrastructure to maintain them.

[7] Unfortunately, ratings agencies have not proven to be sufficient risk evaluators to provide true comfort.

FHCs Possess Sophisticated Risk Management Abilities: Given the nature of their businesses, FHCs are strong risk managers and have internal controls that require risk mitigation. This skill set permits FHCs to undertake transactions with physical energy companies and cost-effectively and efficiently lay the risk off to the market in conjunction with the FHC's overall book of business. As a result, the FHC can provide competitive pricing and assure performance for the life of the transaction.

A significant component of risk management and associated pricing is FHC participation in physical markets. Through involvement in physical markets, FHCs have market knowledge and access to the full scope of risk management and pricing tools. Physical market participation provides best pricing not only for physical transactions but also for financial transactions. The farther away an FHC is from the dynamics of the cash market, the more it becomes merely a conduit to the financial market rather than a true market participant that can quote best prices and manage its risk. If FHCs are forced from the physical markets, they may not be able to do much more than mark up plain vanilla interdealer swap prices and offer the same to customers.

FHCs Often Have Longstanding Relationships with COPE Members: Physical energy companies often have longstanding relationships with FHCs which go well beyond that of a typical counterparty. FHCs can be lenders, underwriters, or investment banking advisors. These relationships (which are more akin to that of a client) can be of material value in physical transactions between the parties. Notwithstanding the fact that this is a *caveat emptor* world, recognizing such longstanding and broad relationships can result in a long-term business view in which the continued business flow is valued over today's trade. Given the scope of transactions that can occur with FHCs, there is no other similar counterparty type.

There Are Benefits To Physical Commodity Companies in Undertaking Transactions with FHCs That Can Span Financial and Physical Activities: As noted above, due to activities in both physical and financial markets, related transactions spanning those markets between a physical company and an FHC counterparty can be combined such that overall risk and credit issues can be effectively managed. Such transactions may include both physical and financial components or use either physical or financial structures to accomplish the purpose of the transaction in the most efficient and least risky manner. The lien-based example above in which lending and offtake/hedging are combined to benefit all parties is a common and obvious example.

However, it is not the only example. Others include the following:

- An FHC can deliver product to a refinery and also purchase the output, creating an arrangement under which the refiner, which may lack the credit to enter into independent purchase and sale arrangements, can wrap the two together and "secure" the purchase with the sale. This type of transaction is in some ways credit-oriented and requires a sophisticated counterparty such as an FHC. Power tolling agreements can be structured similarly.

- An FHC can enter into a commodity buy/sell arrangement or "commodity repo" in which the FHC purchases the commodity from the physical company and resells/returns it when it is needed by the physical company. This is another credit-oriented transaction to which FHCs are well suited.

- An FHC can enter into a volumetric production payment ("VPP") transaction in which it purchases an ownership stake in oil and/or natural gas production. The FHC is then paid

> over the life of the production. Such a transaction has characteristics similar to a secured loan but may be less risky for the FHC as the ownership stake should not be subject to the risk of a counterparty bankruptcy.

Finally, in addition to being valued counterparties for the reasons set forth above, FHCs have served commodity markets well in their traditional role as market markers. As counterparties with deep reaches into the market and strong credit ties to market participants, FHCs can make markets and enhance liquidity. As traditional intermediaries, FHCs have a well-established role of making markets and quoting bids and offers. They are a real and material element of commodity markets in this role.

The advent of swaps and swap dealer regulation established in the Dodd-Frank Wall Street Reform and Consumer Protection Act[8] has only made the FHC function of a market making intermediary in physical commodity markets more important. Since swaps and physical transactions are part of the same market, many physical companies that previously traded and made markets in both have exited out of concern of becoming a Swap Dealer subject to regulation under Dodd-Frank. As a result, the physical commodity markets are even more dependent upon FHCs for liquidity. Their exclusion would likely have a clear and negative effect on liquidity. This confluence of events by which public policy seems to favor commodity market making by FHCs should be a real component of the Board's consideration here.

<u>The Board's Concerns Are Mitigated by Its Safeguards</u>

While the foregoing addresses the value that physical energy companies see in FHC participation in physical commodity markets, COPE understands that the Board has legitimate concerns about risks to FHCs from such participation. COPE will not address financial elements of the Board's inquiry at great length but offers the following observations.

The Board notes that there have been environmental catastrophes effecting energy companies such as the Deepwater Horizon and San Bruno events.[9] COPE understands that such events could have a material negative financial effect on an FHC if it were owner/operator of such facilities. COPE notes, however, that FHCs can finance energy facilities that can be subject to foreclosure. As such, they are subject (as lenders) to the loss of their loan and, upon foreclosure, the environmental risk of ownership. COPE is not aware of there being a concern regarding such lending activities. Further, COPE does not see today and does not anticipate FHCs engaging in offshore drilling in the manner of BP in Deepwater Horizon or natural gas distribution like PG&E performed in San Bruno.

Rather, as stated above, COPE sees value in FHCs participating in physical trading, merchandising, finance-like transactions, risk management, and other activities that are, as the Board has stated, complimentary to their core functions. Even though these activities may have limited physically-related risks, they are not on a par with the catastrophes identified by the Board.

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[8] Public Law No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank"); Dodd-Frank at § 731 (Registration and Regulation of Swap Dealers and Major Swap Participants).

[9] ANOPR at 3331.

In many cases, for example with respect to electricity, natural gas, and oil/refined products, owners of the energy commodity do not have care, custody, and control of the products which are shipped and stored by regulated transportation and storage providers. Primary liability for environmental impacts and risk of loss is with the service provider, not the product owner/shipper. If further liability for shippers exists (and that is not always clear), FHCs typically acquire significant insurance to cover it. COPE does not believe that physical commodity trading as described would give rise to imprudent and unduly burdensome risk that would be beyond what is proper for an FHC.

In the ANOPR, the Board questions whether the current safeguards it has imposed are adequate. Those safeguards include: limitation on the size of physical commodity trading in relation to consolidated tier 1 capital;[10] a bar on ownership by FHCs of facilities for the extraction, transportation, storage, or distribution of commodities as well as processing, refining, or otherwise altering commodities;[11] and, where permitted, certain risk-minimizing standards relating to energy tolling and energy management services.[12] Further, FHCs are generally limited to physical commodity activities that are approved by the Commodity Futures Trading Commission for trading on a US futures exchange.

COPE believes that the safeguards noted above are well-suited to ensure the safety and soundness of FHCs. For the reasons stated above with respect to potential liability stemming from physical operations, the limitations on magnitude, and the requirement that the commodities be those that can be hedged with futures, the safeguards effectively place FHCs in their familiar role of traders and market makers. To COPE's knowledge, these safeguards have worked well and no FHC's physical commodity activities have posed a meaningful risk to its safety and soundness (unlike some financial activities). As noted above, lending related to activities from which FHCs are barred may pose a greater risk.

Thus, given the significant benefits to the commodity markets by FHC participation, the limited and well-circumscribed risk resulting from these complementary activities should not be viewed as excessive or require regulatory change from the *status quo*.

Conclusion

For the reasons stated above, COPE requests that the Board continue to permit FHCs to perform their valuable role in physical commodity markets.

Respectfully Submitted,

/s/ David M. Perlman

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CC: COPE Members

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[10] *Id.* at 3330.

[11] *Id.*

[12] *Id.* at 3330-1.