Electric Power Supply Association
Advocating the power of competition

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[VIA E-Mail]
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
Docket No. 1479
RIN 7100 AE-10

Dear Mr. deV. Frierson:

Please find below the comments of the Electric Power Supply Association ("EPSA") in response to the Advance Notice of Proposed Rulemaking ("ANOPR") issued by the Board of Governors of the Federal Reserve System ("Board" or "Federal Reserve") inviting public comment on various issues related to physical commodity activities conducted by financial holding companies.

EPSA appreciates the opportunity to comment on this important ANOPR and to highlight the importance of robust, liquid physical commodity trading markets, particularly in the energy industry. This liquidity is particularly important as we face external factors that are impacting the reliability and efficiency of the wholesale electricity markets. Therefore, all tools which allow electricity to be generated, delivered and sold as reliably and efficiently as possible should be supported by policymakers.

EPSA is the national trade association representing leading competitive power suppliers, including generators and marketers. Competitive suppliers, which, collectively, account for 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities. EPSA seeks to bring the benefits of competition to all power customers. These comments represent the position of EPSA as an organization, but not necessarily the views of any particular member with respect to any issue.

EPSA members are physical commodity market participants that rely on swaps and futures contracts primarily to hedge and mitigate their commercial risk. Under the competitive wholesale business model, electricity suppliers, including EPSA members, assume vastly more risks on behalf of consumers than is the case for more traditional cost-of-service regulated utilities. EPSA members are commercial end-users that rely on hedging strategies to mitigate the price volatility associated with fuel and power generation.

The Federal Reserve has issued an ANOPR asking several questions about the various authorities Bank Holding Companies ("BHC") and Financial Holding Companies ("FHC") received from the Federal Reserve.

Background

Starting in the early 2000's, under the authority of the amended Gramm-Leach-Bliley Act[1], the Federal Reserve began granting certain BHC and FHC authority to engage in activities determined to be complementary to a financial activity and that do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. In addition, the Board must consider whether the BHC or FHC conducting these complementary activities may reasonably be expected to produce benefits to the public, including greater convenience, increased competition, and/or gains in efficiency that outweigh possible adverse effects, including undue concentration of resources, decreased or unfair competition, conflicts of interest, unsound banking practices, or risks to the stability of the banking and financial system.[2]

Using these criteria, the Board has previously approved requests by FHC to engage in three specific types of complementary activities, including Energy Tolling Agreements, Energy Management Services, and physical commodity trading involving the purchase and sale of commodities in the spot market, and

[1] Gramm-Leach-Bliley Act § 103, [12 U.S.C. § 1843(k)(a)(B)]
[2] 12 U.S.C. § 1843(j).

taking and making delivery of physical commodities to settle commodity derivatives.[3]

The Board recently initiated a review of the authorities given to the BHC and FHC over the last ten years. As explained in the ANOPR, FHC "are permitted to engage in a limited amount of physical commodity trading activity that the Board has determined to be complementary to various financial activities in accordance with section 4(k)(1)(B) of the Bank Holding Company Act."[4] The Board indicated that several recent events provided a basis for the need to review these authorizations, including recent environmental catastrophes that raised concerns that the costs of preventing accidents or paying for damages may exceed "the market value of the commodities involved or the committed capital and insurance policies for market participants."[5] The Board also identified the recent financial crisis as a reason to review authorizations noting that "currently, 11 of the 12 FHC that are authorized to engage in one or more Complementary Commodities Activities are also designated as global systemically important banks..."[6]

In the ANOPR, the Federal Reserve asks "In what ways are non-BHC participants in the physical commodities markets combining financial and non-financial products or services in such markets?"[7]

<u>Physical Energy Markets and Trading</u>

To understand how participants in the energy trading space are combining financial and non-financial products or services, it is helpful to understand how the physical energy markets operate. In his January 15, 2014 testimony before the Senate Subcommittee on Financial Institutions and Consumer Protection, Federal Energy Regulatory Commission ("FERC") Director of the Office of Enforcement, Norman Bay, explained the important link between the physical markets and financial markets for energy traders. Mr. Bay explained that "financial and physical energy markets are interrelated: physical natural gas or electric transactions can help set energy prices on which financial products are based…"[8]

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3 ANOPR at 4.
4 ANOPR at 2.
5 ANOPR at 5.
6 ANOPR at 8.
7 ANOPR at 13.
8 Testimony of Norman C. Bay, Director, Office of Enforcement, Federal Energy Regulatory Commission Before the Committee on Banking; Financial Institutions and Consumer Protection Subcommittee, United States Senate, January 15, 2014 at 4. Available at:

Two examples of how EPSA members use financial and non-financial products and services include using them to make decisions on existing and new resources, and to ensure consistent prices and revenues for physical power producers, known as hedging. For instance, EPSA members are making decisions on an ongoing basis regarding whether to keep, retire, upgrade, or re-power substantial amounts of power generation facilities. These decisions are being informed currently by low or no demand growth, low natural-gas prices, EPA and other expected regulatory rules, and other external factors. The ability of EPSA members to secure a multi-year hedge is an important factor in their decision whether to maintain, retire, or upgrade power generation facilities. Additionally, as EPSA members have seen wholesale power prices plunge 40-50 percent in the last several years, the ability of EPSA members to hedge with banks and credible counterparties has allowed suppliers to minimize the impact of such price plunges, or similarly to minimize the impact of price volatility of fuel feedstock used to generate power. Without the ability to hedge and protect against such drastic price declines or changes, the effects on the individual companies, as well as the power markets and the ultimate consumers, would have been much more drastic and in some instances, potentially financially devastating.

When discussing the issue of limitations on BHC and FHC actions in physical energy markets, Mr. Bay explained that, while FERC has not taken any view on the participation of financial entities, including BHC and FHC in FERC-regulated energy markets as opposed to more traditional participants (such as utilities, natural gas pipeline owners, and generators, including EPSA members), FERC sees participation from a variety of market participants as favorable. Mr. Bay stated that FERC's "general view has been that financial institutions of all kinds, as well as energy companies of all kinds, can benefit markets in numerous ways, for example by providing liquidity to market participants who may want to hedge their own risk."[9] Mr. Bay went on to explain that banks and FHC "have generally played a role in the physical wholesale electric market" and stated that "sales by banks and [FHC] represent 13 percent of total revenues for energy and 'booked out power' (energy or capacity contractually committed for delivery but not actually delivered because of an offsetting trade)… and full year electric sales by financial institutions were approximately $15 billion in 2012, down from $45 billion in 2008 for those companies."[10] While BHC and FHC play a role in the ownership of physical assets in the energy and power sector, as

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http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=d3d5a9a5-fbc8-4ef7-96e1-5314d849156c (last accessed February 27, 2014) ("Bay Testimony").

[9] Bay Testimony at 11.

[10] Bay Testimony at 12.

of June 2013, they own less than 4 percent of the total U.S. generator nameplate capacity, which represents the maximum rated output for a generator, and they own less than one percent of the total U.S. natural gas storage capacity and 14 percent of total U.S. natural gas pipeline miles.[11]

As indicated above, EPSA members are physical commodity market participants and end-users. They are not BHC or FHC, yet many of them rely on BHC or FHC to serve as appropriate counterparties for physical commodity transactions.

Importance of BHC and FHC Complementary Authority

The Federal Reserve also asks how the elimination of the Complementary Authority for FHC might affect FHC customers and the relevant markets.[12] This is of great importance to EPSA members as customers of FHCs and participants in relevant markets, who would therefore be significantly impacted by any limitation of FHC Complementary Authority.

EPSA members rely on robust commodities markets to provide access to a variety of credit-worthy counterparties, including BHC and FHC, that can reliably make markets, provide risk-management services, extend credit, and engage in other activities that support commodity trading. Among the specific services that BHC and FHC provide to EPSA members is the ability to hedge with a well-qualified counterparty. EPSA members' ability to enter into hedging transactions with a wide variety of well-qualified counterparties increases competition in the physical power and wholesale electricity markets as a result of more participants in the market providing greater liquidity. The increased competition that results from hedging with cost-effective, credit-worthy counterparties, including BHC and FHC, is critical to EPSA members. This is in large part because the wholesale markets in which EPSA members operate do not have long-term price signals for the energy output of the power plants. While capacity prices are set three years ahead in many regions, energy is sold in day-ahead and real-time markets. Energy represents well over two-thirds to three-fourths of the revenues for EPSA members, and hedging is one of the best ways EPSA members manage this risk.

EPSA members, and other end-users, want the options and ability to work with a variety of potential counterparties, including BHC and FHC. If the BHC and FHC are not part of that pool of potential counterparties, then it leaves EPSA members and other end-users with limited options of hedge funds and other

[11] Bay Testimony at 12-13.
[12] ANOPR at 14.

counterparties that operate under less regulation and oversight than the BHC and FHC and, likely, do so at higher costs to EPSA members and the ultimate consumer.

EPSA also points out that BHC and FHC serve as reliable, credible counterparties for many reasons. For instance, banks are extensively regulated and subject to supervision by multiple governmental agencies, including the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, and the Federal Reserve, just to name a few. Because of this regulatory oversight, and the fact that most are publicly-traded companies, BHC and FHC tend to be more transparent than hedge funds or other entities. BHC and FHC are generally well-capitalized entities, with strong balance sheets which helps to ensure their ability to protect against unexpected swings in the market. Additionally, BHC and FHC can provide multiple products and services to their counterparties.

Another example of the impact of BHC and FHC exiting the commodities markets that EPSA members are already experiencing relates to the forward prices in the energy and capacity markets failing to accurately reflect the market fundamentals as a result of reduced liquidity in the markets. This issue of proper price formation for the wholesale energy and capacity markets is being examined extensively by the FERC, as well as many other market participants. FERC recently held several technical conferences to examine the issue of ensuring markets function to provide appropriate price signals to market participants.[13] Additionally, the U.S. Senate Committee on Energy and Natural Resources just held a hearing to examine issues related to the security and reliability of the electricity grid,[14] which underwent an important stress test this past winter due to extreme cold weather events. As highlighted by Senators and participants on two panels addressing these issues, though the system largely passed this test this year, there are concerns regarding the maintenance of a reliable system several years forward. Therefore, all tools which assist in supporting that end are important.

[13] *Centralized Capacity Markets in Regional Transmission Organizations and Independent System Operators*, Docket No. AD13-7-000, Technical Conference held September 25, 2013 *and Winter 2013-2014 Operations and Market Performance in Regional Transmission Organizations and Independent System Operators*, Docket No. AD14-8-000, Technical Conference held on April 1, 2014, (Notice issued February 21, 2014).

[14] U.S. Senate Committee on Energy and Natural Resources, *Full Committee Hearing on Keeping the Lights On – Are We Doing Enough to Ensure the Reliability and Security of the US Electric Grid?* April 10, 2014. Webcase available at: http://www.energy.senate.gov/public/index.cfm/hearings-and-business-meetings?ID=791ff8ea-66db-4a9f-987c-c15bfef8be41

With several BHC and FHC exiting the physical commodities markets, including the wholesale energy markets, EPSA members have experienced reduced liquidity and tighter availability of counterparties with which to engage. Furthermore, many of the counterparties left in the physical energy markets are only willing to enter into short-term contracts, which ultimately distorts the forward prices of power upon which EPSA members rely to determine how to proceed in the markets and take appropriate actions to ensure the availability of reliable electricity for sale in the wholesale markets. Without the ability to engage with a wide variety of counterparties, including BHC and FHC, EPSA members' ability to compete in the wholesale electric markets and continue to provide reliable and affordable electricity could be in jeopardy. As highlighted by recent FERC and congressional hearings, market structures that support and foster competitive energy markets are critical to ensure the most reliable and affordable system for consumers.

Therefore, EPSA is concerned that action limiting BHC and FHC involvement in these markets, such as limiting or revoking their authority to engage in Complimentary Commodities Activities, could have unintended consequences on energy end-users, including EPSA members. Such unintended consequences could include limiting qualified counterparties available for EPSA members to engage in hedging and risk management transactions. Additionally, the absence of such well-qualified counterparties could have a negative impact on EPSA members' and other end-users' ability and opportunity to finance capital projects, which would increase costs for EPSA members and other end-users, as well as the ultimate consumer.

For all of the reasons stated above, EPSA is concerned that limiting BHC and FHC involvement in physical commodities markets could have unintended consequences on energy end-users, including EPSA members. As such, we appreciate the opportunity to comment in response to some of the questions posed in the ANOPR and request that the Federal Reserve consider the possible impact on end-users and the overall markets in which end-users transact in evaluating any further action on this issue.

EPSA welcomes the opportunity to further discuss these comments with the Board. If we can provide any further information, please do not hesitate to contact us.

Respectfully submitted,

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