ALON USA

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February 20, 2017

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

Via E-mail

**Re: Comment to Notice of Proposed Rulemaking – *Regulations Q and Y; Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-Based Capital Requirements for Merchant Banking Investments* [Docket No. R-1547; RIN7100 AE58]**

Dear Mr. Frierson,

Alon USA Energy, Inc. ("Alon") respectfully submits this letter in connection with the Board of Governors of the Federal Reserve System's (the "Board") Notice of Proposed Rulemaking (the "Proposed Rule") regarding the physical commodities activities conducted by financial holding companies ("FHCs").[1] We are submitting this comment because our business both relies on FHC market making functions and regularly transacts with FHC counterparties in physically settled commodity transactions to support our operations.

The Proposed Rule ignores market reliance on FHCs, and we remain concerned that the Board has not fully considered the impact additional regulation of physical commodities will have on commodity market liquidity, depth, and transparency. Although we appreciate the Board's continued oversight of the U.S. financial system, we believe that certain aspects of the Proposed Rule will have unintended consequences on our business. We are concerned that the Proposed Rule's new restrictions on the commodity activities of FHCs and their affiliates, in their totality, would fuel market instability for the commodity-related products on which we depend, hamper our ability to compete and threaten higher prices for our business. We respectfully request that the Board reconsider the downstream effects and costs the Proposed Rule may have on market participants and revise the Proposed Rule accordingly.

## A. Background on Alon

Alon is headquartered in Dallas, Texas, and is an independent refiner and marketer of petroleum products, operating primarily in the South Central, Southwestern and Western regions of the United States. Through our subsidiary, Alon USA Partners, LP (NYSE: ALDW), we own a crude oil refinery in Big Spring, Texas, with a crude oil throughput capacity of 73,000 barrels per day and an integrated wholesale marketing business. In addition, Alon directly owns a crude

[1] Notice of Proposed Rulemaking, *Regulations Q and Y; Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-Based Capital Requirements for Merchant Banking Investments*, 81 Fed. Reg. 67220 (Sept. 30, 2016) [hereinafter the "Proposed Rule"].

per day and an integrated wholesale marketing business. In addition, Alon directly owns a crude oil refinery in Krotz Springs, Louisiana, with a crude oil throughput capacity of 74,000 barrels per day. Alon also owns several crude oil refineries and a majority interest in a renewable fuels facility in California, with a throughput capacity of 2,500 barrels per day.

We are by no means a large-scale operation, however, our refining business relies on the regular use of physical commodities and commodity-based derivatives. Therefore, it is critical for our business to timely access these markets in order to hedge against normal and expected price volatilities while maintaining stable cash flows and serving our customers. For example, we hedge the margin between refined petroleum product prices and crude oil to mitigate our crack spread risk with respect to a portion of our expected gasoline and diesel production. We enter into these arrangements with the intent to secure a minimum fixed cash flow stream on the volume of products hedged during the hedge term, which is vital to the successful operation of our business in a volatile industry. To ensure future financial stability, we rely upon FHC counterparties to address our hedging needs.

## B. The Proposed Rule Will Reduce Market Depth

Due to our direct exposure to oil and petroleum markets, we rely on highly liquid and competitively priced commodity markets to ensure that our risks are properly addressed. We are concerned that the Proposed Rule would decrease overall market depth in a sector that has already retracted due to increased legislative and regulatory scrutiny. Increased burdens on the activities of FHC counterparties have prompted a reduction in the number of banks willing to transact in physical commodities.[2] We have directly witnessed market retraction since the Financial Crisis: JPMorgan Chase, Barclays, and Deutsche Bank, for example, have all reduced their commodities activities. We are concerned that the Proposed Rule would further fuel the exodus of FHC counterparties within the financial markets due to: (1) increased risk weighting for Section 4(o) FHCs and (2) restrictions on Section 4(k) complementary authority.

The Proposed Rule would effectively push out market-makers by rendering Section 4(o) uneconomical. The proposed risk weighting assigned by the Board to certain physical commodities that could be held by FHCs under Section 4(o) authority is punitive and is an overreaction to the risks it seeks to address. In particular, we are concerned that a 1,250% risk weighting for these Section 4(o) exposures would needlessly force FHCs to retain more in total capital than the actual value or risk of the exposure in order to meet well-capitalized status, thus increasing costs for us to effectively manage risk. For example, a $100 million asset held under Section 4(o) authority would require an FHC to hold $125 million in total capital to maintain a 10% Total Capital/RWA ratio. It is likely that these additional capital burdens would be passed on to businesses like ours. The effect of the Proposed Rule would be to push FHCs out of the market by rendering Section 4(o) impractical and uneconomical.

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[2] The Advanced Notice of Proposed Rulemaking notes that 14 FHCs are currently authorized to engage in physical commodities activities, either under Section 4(k) or Section 4(o) of the BHCA. *See* Advance Notice of Proposed Rulemaking, *Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities*, 79 Fed. Reg. 3329 (Jan. 21, 2014).

Compounding this problem is the fact that the Proposed Rule would further limit FHCs' ability to rely on Section 4(k) complementary authority. Assets held under Section 4(k) would be further limited in total asset size and assigned a 300% risk weighting. Currently, an FHC's national bank subsidiary can hold physical commodities in amount equal to 5% of its total notional value of its derivatives in that particular commodity. The Proposed Rule would limit an FHC's derivatives activities by now counting it towards the 5% of Tier 1 Capital that the Board has imposed under Section 4(k). By increasing capital requirements under both Section 4(k) and 4(o), the Proposed Rule would deter prudent risk management and expose us to unnecessary and costly market risks.

The practical implications of the Proposed Rule and the real possibility of a market with limited FHCs would adversely affect Alon by increasing prices and reducing the number of sophisticated parties in which we rely on to efficiently hedge, finance and otherwise transact within the commodities market.

## C. The Proposed Rule Will Reduce Liquidity, Price Convergence and Market Solutions.

As a market participant in physical commodities and commodity-based derivatives, we wish to emphasize that efficient markets require depth, competence and narrow pricing spreads. We are concerned that, especially in the markets for highly-customized commodity products, a retreat by FHC affiliates will lead to greater market illiquidity, greater price variation and a reduction in market solutions.

### *1. Liquid markets are needed to effectively and efficiently manage risk*

The current participation of FHCs and their affiliates as market-makers in physical commodities increases the liquidity of the market, reduces bid and ask pricing, increases the overall volume of commodities products, and reduces price volatility. In facilitating the exchange of physical commodities, FHCs help to stabilize commercial growth by providing a mechanism in which businesses can manage their short- and long-term inventory needs. For example, change in our plant operations, such as those experienced during maintenance turnarounds, requires the storage of additional inventories. We enter into arrangements with FHC's to hedge these excess inventories and reduce exposure to changes in commodity prices. The Proposed Rule, however, would drastically reduce an FHC's ability to provide such services by increasing funding costs and limiting their reliance on Section 4(k). As FHC affiliates are frequently the most knowledgeable, most willing and most equipped participants to address our market-necessary customized trades, we will likely experience a drastic reduction in the volume and variety of commodities-based products.

### *2. Transparent markets are needed to effectively and efficiently manage risk*

As market participants and operators of physical commodity refineries, we rely on accurate and efficient pricing of physical commodities. Unlike other financial products, commodity instruments are directly related to the physical product itself. Under the current regulatory authority of Section 4(o) and Section 4(k), the volume of commodities-based transactions by FHCs help to reduce any inefficiency in the market by better converging prices of the financial instrument and the correlating physical commodity.

The Proposed Rule, however, ignores this critical function and instead would increase price differentiation between the physical and financial asset. Moreover, the elimination of FHC involvement within this market would subject us to increased risks due to price differences and market arbitrage. As a refiner we hold physical positions in products and crude oils that are not actively traded. In these cases, we rely on the ability of FHCs to make markets to reduce the basis risk we would otherwise encounter.

3. *Sophisticated markets are needed to effectively and efficiently manage risk*

While proponents of the Proposed Rule have often argued that market forces will step in to address any decrease in FHC activity, we would note that it is highly unlikely that these new parties would possess the institutional knowledge, economies of scale and overall sophistication that FHCs currently provide to the markets. It is for this reason that Alon does not engage with non-FHC counterparties, as we require practical market solutions to transparency, bid/ask pricing, and the.

In particular, we would note that many non-bank institutions, when compared to FHCs, lack the capital necessary to engage in large trades; do not provide the economies of scale and cost-savings; tend to focus on niche areas of the commodities market (e.g., dealing only in certain commodities); cannot provide a one-stop financing and hedging solution; are relatively less sophisticated; and most importantly, will likely only engage in this space to meet their discrete needs. For the past six years, an FHC has held the majority of the inventories necessary to operate our business. This requires the FHC the accept the basis risk associated with holding significant volumes of a wide variety of crude oils and petroleum products, priced in different markets for multi-year terms. Our business also requires us to hold varying levels of inventories throughout the year, including some types of products that would not otherwise be financeable. Non-FHC market participants would likely be unable to address our needs in a holistic manner.

In contrast to non-bank institutions, FHCs are sophisticated entities that serve as critical intermediaries with interests in both the buy and sell side of the commodities market. Among other benefits, FHCs are large enough to operate across the market, provide depth and transparency to less opaque commodities (e.g., coal), are better equipped to tailor products to individual companies, provide financing solutions for commodity rich businesses, and provide an economical venue in which to hedge commodities risks. For example, the presence of FHCs in the commodities markets allows us to enter into hedges for our crude supply and petroleum products at prices determined by the markets in which we are operating. If FHCs depart the commodities markets due to additional regulation, we believe we would be forced to enter into hedges at prices determined by markets other than those in which we operate, such as New York Harbor prices, which would entail significant additional basis risk for our company. Additionally, an FHC's low cost of capital allows for flexibility to provide commodity financing solutions that are more attractive to Alon than a traditional asset-backed financing facility.

**D. Conclusion**

It is for these aforementioned reasons that additional restrictions and limitations on the physical commodity activities of FHCs should be reconsidered in light of the detrimental effects they would have on end-user businesses. Due to these economic burdens and risks, we respectfully urge the Board to table further rulemaking and maintain, if not scale back, conditions that currently benefit market participants as a result of FHC commodity activities.

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Thank you for your consideration of our comments to the Board's Proposed Rule. We look forward to working with the Board as it continues to consider this important issue.

Please contact me at (972) 367-3669 or Shai.Even@AlonUSA.com if you have any questions or if you would like to discuss our comments in more detail.

Sincerely,

Shai Even

Shai Even
Alon USA Energy, Inc.
Senior Vice President &
Chief Financial Officer