



February 20, 2017

Via Electronic Submission

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

**RE: 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; RIN 7100 AE-58**

Dear Mr. Frierson,

I. Introduction

The Edison Electric Institute ("EEI") and the National Rural Electric Cooperative Association ("NRECA") (hereafter "Joint Associations") respectfully submit these comments in response to the Notice of Proposed Rulemaking ("Proposed Rule") issued by the Board of Governors of the Federal Reserve System (the "Board") to adopt additional limitations on physical commodity trading activities conducted by bank holding companies ("BHCs") and financial holding companies ("FHCs") and to increase the capital requirements associated with these activities.¹ The Joint Associations appreciate the opportunity to comment on this important Proposed Rule and to highlight the importance of robust, liquid physical commodity trading markets to the energy industry.

EEI is the association of U.S. shareholder-owned electric companies. EEI's members comprise approximately 70 percent of the U.S. electric power industry, provide electricity for 220 million Americans, operate in all 50 states and the District of Columbia, and directly employ more than 500,000 workers. With more than \$100 billion in annual capital expenditures, the electric power industry is responsible for one million jobs related to the delivery of power.

¹ 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, Notice of Proposed Rulemaking, 81 Fed. Reg. 67220 (September 30, 2016) ("Proposed Rule").

NRECA is the national service organization for more than 900 not-for-profit rural electric utilities that provide electric energy to more than 42 million people in 47 states or 12 percent of electric customers. Kilowatt-hour sales by rural electric cooperatives account for approximately 11 percent of all electric energy sold in the United States. Because an electric cooperative's electric service customers are also members of the cooperative, the cooperative operates on a not-for-profit basis and all the costs of the cooperative are directly borne by its consumer-members.

The Joint Associations' members are physical commodity market participants that rely on bilateral physical power and natural gas contracts to supply customers with reliable electric service and to hedge and mitigate their commercial risk. Regulations that make effective risk management opportunities more expensive for commercial users of physical commodity contracts will likely lead to higher energy prices if the costs associated with new regulations are passed through to retail energy consumers and commercial and industrial electric consumers, or will result in more volatile prices if commercial users decide to forward hedge a smaller portion of their commercial risk. The Joint Associations' members rely on banking entities and their affiliates as counterparties to energy commodity forward contracts and commodity trade options to hedge and mitigate their commercial risks. Accordingly, the Joint Associations and our members have a direct and significant interest in the Proposed Rule.

As further explained below, the Joint Associations are concerned that the Proposed Rule, especially as related to capital requirements, will have unintended consequences on our members' ability to find counterparties for physical supply and hedging transactions. The Joint Associations' members need liquid, efficient, and competitive physical and derivatives markets to hedge exposure to price risk. The Joint Associations respectfully request the Agencies to consider the potential unintended impact of the Proposed Rule on physical commodity market participants, including the members of the Joint Associations.

II. Comments

Pursuant to its authority under the amended Gramm-Leach-Bliley Act ("Act"),² the Federal Reserve granted certain BHCs 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. The Board must also consider whether the BHCs or FHCs 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. Using this analysis, the Board has previously approved requests by FHCs to engage in three specific types of complementary activities, including Energy Tolling Agreements,

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

³ 12 U.S.C. §1843(j).

Energy Management Services, and physical commodity trading involving the purchase and sale of commodities in the spot market, and taking and making delivery of physical commodities to settle commodity derivatives.

While the Proposed Rule contains a number of proposed changes, the Joint Associations are especially concerned about the proposal "to amend the Board's risk-based capital requirements to increase the requirements associated with physical commodity activities and merchant banking investments in companies engaged in physical commodity activities to better reflect the potential risks of legal liability associated with a catastrophic event involving these physical commodity activities."⁴ The Proposed Rule would substantially increase the regulatory capital requirements for FHCs that hold inventories of certain physical commodities, including generation fuel commodities (natural gas, coal, and uranium). Under the Proposed Rule, risk weights for these transactions would be increased to maximum levels. FHCs would be subject to a 300 percent risk weight for their holdings of physical commodities; and, if a FHC's total amount of physical commodities exposure were to exceed 5 percent of its Tier 1 capital, then the excess amount would be subject to a risk-weight of 1,250 percent. The Joint Associations are concerned that the proposed change will make effective commercial risk management opportunities for our members, more difficult and more expensive by disincentivizing banking entities from engaging in energy industry transactions.

Since 2003, participation by BHCs and FHCs in the U.S. wholesale physical energy commodity markets has enhanced market liquidity, particularly in the energy commodity categories that are important for electric utilities to supply customers with affordable and reliable electric service. These energy commodity categories include electric energy and capacity, as well as commodities that are fuel for electric generation such as natural gas, coal and coal products, and uranium and uranium products. In the mid-1990s, the U.S. wholesale electric markets were deregulated and forward contracts in electric energy, capacity, generation fuel commodities, and commodity derivatives became important planning and supply resources for electric utilities. FHCs participate in bilateral physical power and natural gas markets, electricity markets operated by regional transmission operators ("RTO") and independent system operators ("ISO"), bilateral OTC swaps markets, and listed derivatives (futures) markets.

FHC participation in these markets has been particularly important to electric utilities and other commercial market participants, many of which have entered into forward contracts and commodity trade options to manage supplies of electricity and fuels, as well as commodity derivatives to hedge the forward cost of such commodities. Although electric energy and capacity are not "covered physical commodities" under the Proposed Rule, making substantial increases in the regulatory capital requirements for FHCs' holdings of generation fuel commodities will have indirect cascading effects on the wholesale physical electric markets as well. By increasing the capital requirements associated with holding inventories of physical

⁴ Proposed Rule at 67225.

commodities, the Proposed Rule will reduce the number of available counterparties for these transactions, especially long-term customized transactions, which will increase volatility. The increased costs created by these burdens will ultimately be passed down to end-use customers.

While FHC activity in physical commodity markets has declined for a number of reasons including but not limited to the move to exchange cleared transactions, regulatory changes, and market conditions, FHCs continue to serve an important role in providing longer-term or customized transactions. Thus, while transactions with FHCs do not generally constitute a large percentage of the overall number of generation fuel transactions, they constitute a large percentage of the long-term, customized transactions, many of which are intended to settle by physical delivery. Since there are not a large number of creditworthy counterparties that are able to enter into these types of transactions, the effect of FHCs leaving this space will have an immediate impact on the ability of the Joint Associations' members to enter into transactions needed to hedge or mitigate the commercial risks of their electric operations and provide stable rates for end-use residential, industrial, and commercial customers.

The explanation provided in the Proposed Rule for raising the capital requirements does not justify the impact on energy markets. The Federal Reserve Board acknowledges that its current proposal is prompted by continuing unquantified concerns and fears as a result of high profile events, such as the Deepwater Horizon oil spill⁵, that FHCs' already highly regulated involvement in the physical commodity markets **could** cause uninsurable costs in the case of an environmental disaster, or **may** result in FHC reputational risk as a result of actual or suspected conflicts of interest. The proposal does not quantify how, or by what measure, the additional regulations in the proposal will achieve quantifiable benefits or significant reduction in these perceived risks.⁶ Rather, the unstated assumption is that further restricting participation in the physical commodity markets, by whatever measure, must result in additional safety and soundness benefits.

By contrast, commercial entities that participate in such markets, and benefit from FHC participation in such markets, provided comments on the Board's ANOPR⁷ in strong support of the benefits they see from continued FHC involvement in physical commodity activities, and actual costs in reduced market liquidity from current regulation. Like the Joint Associations, these market participants oppose additional regulatory restrictions and costs imposed on such FHCs.⁸ The proposal's substantial increases in the regulatory capital requirements and cost for FHCs to participate in the wholesale physical energy commodity markets will either increase costs that must be recovered by FHCs from their counterparties and customers, or will cause such FHCs to discontinue or cut back their historically significant participation in these markets.

⁵ See Proposed Rule at 67222.

⁶ See Proposed Rule at 67,225.

⁷ 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).

⁸ See Proposed Rule at 67,224-67,225.

Reduced participation by the FHCs will mean less market liquidity, less competition, and less affordable supplies of generation fuel commodities that will ultimately increase the market risks and costs for residential and commercial electric customers.

As was discussed in end-user comments in response to the ANOPR, another reason that FHCs are important counterparties for U.S. electric utilities is due to their nature as well-capitalized, creditworthy entities with well-understood business models and regulatory structures. Evaluating the creditworthiness of an FHC participating in the U.S. energy markets is a straightforward exercise for electric utility counterparties and customers, both from a quantitative and a qualitative assessment. It is possible that, at some point in the future, private funds or commodity trading firms may help to fill the void in the physical energy commodity markets that would be created if the FHCs reduce or discontinue their participation in these markets. However, as privately held commercial entities, each with a unique business model, it is and will be more challenging for electric utilities to evaluate the creditworthiness of such private funds or commodity trading firms as counterparties, and to be confident of assessing them quantitatively, but in particular qualitatively. As such, the Proposed Rule will reduce not only the number of counterparties but the number of creditworthy counterparties for electric utilities.

III. Conclusion

The Joint Associations appreciate the opportunity to submit comments in response to the Proposed Rule. As discussed above, the proposal to increase regulatory capital requirements for FHCs' holdings of generation fuel commodities will have a substantial impact on liquidity in the energy markets and the ability of electric utilities to find creditworthy counterparties. As such, the Joint Associations request that the Board consider the adverse effects of this Proposed Rule on electric utilities as counterparties and customers of FHCs, particularly in regional U.S. markets for electric energy, capacity, and generation fuel commodities, and ultimately the adverse effects on end-use electric consumers, before proceeding with this proposal.

Respectfully submitted,

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