Black Belt Energy

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February 15, 2019

Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
400 7th Street SW, Suite 3E-218
Washington, DC 20219
Regs.comments@occ.treas.gov

Federal Deposit Insurance Corporation
Robert E. Feldman, Executive Secretary
550 17th Street NW
Washington, DC 20429
comments@FDIC.gov

Board of Governors of the Federal Reserve System
Ann E. Misback, Secretary
20th Street and Constitution Avenue NW
Washington, DC 20551
Regs.comments@federalreserve.gov

Re: Comment to Notice of Proposed Rulemaking – Standardized Approach for Calculating the Exposure Amount of Derivative Contracts:
OCC, Capital Adequacy: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, Docket ID OCC-2018-0030;
Federal Reserve Docket No. R-1629 and RIN 7100-AF22;
FDIC Docket No. RIN 3064-AE80]

The Black Belt Energy Gas District ("Black Belt"), a public corporation organized as a gas district under the laws of the State of Alabama, appreciates the opportunity to provide comments in response to the Notice of Proposed Rulemaking regarding proposed revisions to the standardized approach for calculating the exposure amount ("SA-CCR") of derivatives contracts of financial holding companies (the "Proposed Rule").[1] The Proposed Rule, issued jointly by the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System (the "Board"), and the Federal Deposit

[1] The Notice of Proposed Rulemaking was made available on December 17, 2018 and provided sixty days for public comment. During the sixty-day period, a significant portion of the United States government ceased operations for thirty-five days for lack of authorized appropriation of funds. The period also included federal holidays on which the government was closed. It is suggested that the shortened workable notice period may adversely affect the quantity and diversity of comments submitted, and the Prudential Regulators may wish to consider an extension of the comment periods to allow additional comments to be submitted.

Insurance Corporation (the "FDIC", together with the OCC and the Board, the "Prudential Regulators")[2], threatens to result in significant and unnecessary costs for Black Belt and other end-user companies and organizations. Specifically, Black Belt is most concerned that large banks acting in the role of prepaid gas supplier or commodity swap counterparty in natural gas prepayment transactions will be required, or will interpret the rule as requiring, capital set asides beyond those that currently exist, if any, under current statutory and regulatory standards.

1. Introduction – Black Belt's Participation in Derivatives Markets

Black Belt is a public corporation formed by three member municipalities under the provisions of the Alabama Gas Districts Act, § 11-50-390, *et seq.*, Alabama Code (1975). The member municipalities of Black Belt are the City of Jackson, Alabama; the Town of Grove Hill, Alabama; and the City of Thomasville, Alabama. Black Belt is a governmental entity. Its Board of Directors is comprised of the mayors of its member municipalities.

Black Belt is a joint action gas supply agency that provides wholesale sales service to municipal gas systems both within and outside the State of Alabama. Black Belt also provides natural gas management services for the Louisiana Municipal Gas Authority and for certain large industrial customers. It is an end user that fought for and benefits from the statutory end user exception from mandatory clearing and the statutory exemption from margining requirements.

Black Belt is a continuous participant in the municipal gas marketplace, including the marketplace for long-term gas supplies, and is a participant in derivatives transactions. Long-term gas supplies are essential to enable Black Belt to meet the needs of its customers for reliable, secure, firm natural gas deliveries at reasonable and competitive prices. One of the primary strategies to meet these needs which Black Belt has pursued in recent years, is pursuing today, and intends to pursue in the years to come is the purchase of natural gas supplies through

[2] Prudential Regulators, Notice of Proposed Rulemaking, *Standardized Approach for Calculating the Exposure Amount of Derivative Contracts*, 83 Fed. Reg. 64660 (Dec. 11, 2018), available at https://www.federalregister.gov/documents/2018/12/2018-24924/standardized-approach-for-calculating-the-exposure-amount-of-derivative-contracts [hereinafter, the "Proposed Rule"].

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gas prepayment transactions under Internal Revenue Code Section 148(b)(4) and Treasury Regulations. Large banks and their commodities affiliates are among the primary participants in this marketplace as gas suppliers. As such they provide an essential service to the municipal gas industry, one that we believe could not and would not be replicated or replaced by other industry participants, at least not under market conditions that have prevailed over at least the past 12 years.

Gas prepayment transactions contain matched, customized commodity swaps as essential components. These are so-called "tear up" swaps. There is no mark-to-market exposure to either counterparty upon early termination of the swaps, only exposure for accrued but unpaid amounts owed by one party or the other.

In 2016, Black Belt successfully closed a gas prepayment transaction that will, for the next 30 years, continuously provide discounted gas to governmental joint action agencies and municipal distribution systems across five states – Alabama, Georgia, Kentucky, South Carolina and Tennessee – serving more than 150 cities and towns. Many municipal distribution systems are modestly sized and located in rural areas of the country, In 2017 and 2018, Black Belt successfully closed two other gas prepayment transactions which serve municipal gas customers in Alabama, Georgia, Florida and Nebraska. It is essential to the health of our systems and the customers we serve that Black Belt and other municipal gas systems have the option available to them to purchase long-term natural gas supplies through gas prepayment transactions, which necessarily include matched commodity swaps. Accordingly, any governmental steps, including those contemplated in the SA-CCR NOPR, that would or could increase the cost of doing so would be adverse to the interests of Black Belt, our member municipalities, and all of the consumers we serve – residential, commercial, institutional and industrial. Black Belt's interests are consistent with the interests of the natural gas consuming public who rely on Black Belt gas supply.

2. The SA-CCR NOPR's Effect and Potential Effect

The Prudential Regulators have proposed a new methodology for measuring derivatives counterparty credit risk known as the "Standardized Approach for Counterparty Credit Risk" or "SA-CCR". As proposed, large banks would be required to adopt SA-CCR by July 2020.

As proposed, the SA-CCR methodology would significantly raise banks' capital requirements for natural gas derivatives, with the largest impacts being on derivatives executed with end users, like Black Belt. While banking organizations may absorb some of these increased capital costs, Black Belt fears, and believes, that the potential magnitude of the increase will result in the following:

(1) the transfer of all or a significant portion of the increased cost to end users, including Black Belt, which will have a direct effect on our costs, leading in turn to higher prices for natural gas service for our consumers and a negative impact on the local economy, and potentially making gas prepayment transactions uneconomic for us;

(2) increased pressure on banking organizations to collect margin from end users or submit transactions to exchanges for clearing, notwithstanding the hard-fought efforts by end users, including Black Belt, to be exempt from mandatory margin and clearing requirements; and

(3) a decrease in the overall liquidity in the natural gas derivatives markets, as some banking organizations may choose to exit the market due to higher transaction costs, resulting in increased concentration risk and the lack of access to unique transactions such as prepayment transactions and their customized commodity swaps.

3. Black Belt Energy End User Perspective

SA-CCR proposes increases in capitalization requirements that will increase the cost of doing business for banks participating in the natural gas markets as prepaid gas suppliers and as commodity swap counterparties. This would have the result of increasing the cost of natural gas prepayments for Black Belt and therefore for consumers served by our municipal gas system customers. The economics of gas prepayments in the marketplace that have prevailed over the last several years make the successful completion of such projects difficult. Any increase in the cost to prepaid gas suppliers of providing the supply and/or on counterparties to participate in matched commodity swaps has a negative effect on our ability to close them. We fear that the SA-CCR could convince some banks to withdraw from the physical gas markets and commodity swap markets as it becomes more difficult to operate profitably. A reduction in the number of prepaid gas suppliers in the market will be detrimental to municipal gas systems.

In sum, we are concerned that significant capital requirements for commodity transactions with end users, including municipalities, may significantly affect the ability of municipal organizations such as Black Belt to obtain reliable access to natural gas supplies through gas prepayment transactions, as well as frustrate the policy goals of exempting end users, including municipalities, from mandatory clearing and margin requirements, and ultimately result in increased costs to the consumer.

4. Summary of SA-CCR Issues for End Users

Large banks that face end users as counterparties in derivative transactions are subject to capital requirements imposed by the Federal Reserve. Generally speaking, increases in a bank's capital requirements for a given transaction result in higher pricing for the bank's counterparties. At present, banks' capital requirements include a derivatives counterparty credit risk component called the "Current Exposure Method" or "CEM". The Prudential Regulators have proposed to replace CEM with the new SA-CCR exposure methodology.

As proposed, SA-CCR would penalize large banks' derivative contracts with end users, thereby indirectly penalizing end users themselves, since SA-CCR:

- penalizes un-margined derivatives (even when they are un-margined pursuant to a statutory or regulatory exemption);
- imposes high supervisory factors on commodity transactions in which many end users are active; and

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- disregards non-margin forms of credit support like liens and letters of credit and investment grade (including high investment grade) credit ratings.

If adopted in its current form. SA-CCR would substantially increase large banks' capital requirements related to derivatives with end users, impairing end users' access to hedging and risk mitigation practices that the existing, Congressionally-determined margin and clearing exemptions were designed to facilitate.

End users, including municipalities and other governmental entities like Black Belt, are generally exempted from regulatory margin requirements. SA-CCR penalizes counterparty relationships which do not have initial or variation margin. Physically settled forward contracts are not "Swaps" as defined in Title VII of the Dodd-Frank Act, and thus Congress has not made them subject to the mandatory clearing requirement of Title VII. In the margin rulemaking, the Prudential Regulators, the SEC and the CFTC specifically exempted end users from margin requirements, following the Commodities Exchange Act's exemption of end users from mandatory clearing. SA-CCR will frustrate these policy-based exclusions and exemptions if end users are unable to access derivatives markets or have to bear increased costs to enter into derivatives transactions because of increased margin requirements imposed on their end user counterparties.

SA-CCR does not recognize non-margin forms of collateralization commonly used by end users in lieu of initial or variation margin, including providing banking organizations with liens on physical assets and letters of credit that mitigate the banking organization's credit exposure in the event of counterparty default. Notwithstanding regulatory margin exemptions, there are a variety of credit risk mitigation techniques used when facing end users. Letters of credit probably should be treated as the equivalent of cash collateral. Letters of credit accomplish their purpose by substituting the credit of the bank for that of the customer. The beneficiary is entitled to payment by the issuing bank within a very short time period as long as the beneficiary can provide the documentary evidence required by the letter of credit.

Liens on physical assets, such as oil and gas reserves, are a form of credit risk mitigation that can be used. For example, an oil or gas producer may grant a lien on its reserves as collateral for its hedges of its inventories that it anticipates selling in the future. When oil or natural gas prices rise, the banking organization has credit exposure to the producer, but in these circumstances, the producer's future sales of the commodity will be profitable. When oil or natural gas prices drop, the banking organization has no exposure to the producer because the banking organization owes the producer on the hedge.

In addition, a banking organization's risk management decision to leave an end user derivative exposure uncollateralized – neither collecting initial or variation margin, nor receiving non-margin forms of collateralization – is strongly influenced by whether the end user is an investment grade credit, and the proposed rule does not vary SA-CCR weights based on credit rating status. For non-collateralized derivative exposures, credit rating status is a key consideration, as is the quality or level of the investment grade rating (A versus BBB, for example.

End users often have directional portfolios, which are penalized by SA-CCR, even though a directional derivatives portfolio may be necessary to hedge an underlying non-derivative directional exposure of the end user, meaning that a directional derivatives portfolio typically involves right-way risk.

End users heavily rely on the ability to enter into financially and physically settled transactions in commodities, particularly in the energy sector, which are subject to relatively high SA-CCR supervisory factors. Application of a 40 percent supervisory factor to end users with electricity, oil and natural gas exposures is not representative of the banking organization's underlying credit risk to end users.

Moreover, applying the same supervisory factor for electricity, oil and natural gas does not recognize the different degrees of volatility of these asset groups. Oil and natural gas, which can be stored, are inherently less volatile than electricity.

While electricity prices can be volatile in the spot month, applying a supervisory factor of 40 to electricity is not consistent with the lower degree of volatility in electricity prices in the forward curve, where credit risk to counterparties is relevant. The same is true for natural gas, where the volatility of the forward curve over one, two, or three years is significantly less, and far more relevant, than the spot or prompt month forward curve.

These extremely high supervisory factors for energy transactions will create a punitive impact on the ability of these end users to hedge their risks in these assets and obtain reliable supplies of energy commodities, with the ultimate increase in costs borne by the consumer.

The proposal itself acknowledges the negative impact it will have on the ability of commercial end users, including municipalities, to hedge their risk:

> *"In contrast, exposure amounts would increase for derivative contracts with … sovereigns and municipalities; and commercial entities that use derivative contracts to hedge commercial risk." 83 Fed. Reg. 64685, Column 2*

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Gas prepayment transactions contain matched, customized commodity swaps as essential components. These are so-called "tear up" swaps. There is no mark-to-market exposure to either counterparty upon early termination of the swaps, only exposure for accrued but unpaid amounts owed by one party or the other.

In 2016, Black Belt successfully closed a gas prepayment transaction that will, for the next 27 years, continuously provide from gas supply at discounted prices to governmental joint action agencies and municipal distribution systems across five states – Alabama, Georgia, Kentucky, South Carolina and Tennessee – serving more than 150 cities and towns. Many municipal distribution systems are modestly sized and located in rural areas of the country. In 2017 and 2018, Black Belt successfully closed two other gas prepayment transactions which serve municipal gas customers in Alabama, Georgia, Florida and Nebraska. It is essential to the health of our customers that Black Belt and other municipal gas systems have the option available to them to purchase long-term natural gas supplies through gas prepayment transactions, which necessarily include matched commodity swaps. Accordingly, any governmental steps, including those contemplated in the SA-CCR NOPR, that would or could increase the cost of such transactions would be adverse to the interests of Black Belt, our member municipalities, and all of the consumers we serve – residential, commercial, institutional and industrial. Black Belt's interests are consistent with the interests of the natural gas consuming public who rely on Black Belt gas supply.

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The SA-CCR methodology would significantly raise banks' capital requirements for natural gas derivatives, with the largest impacts being on derivatives executed with end users, like Black Belt. While banking organizations may absorb some of these increased capital costs, Black Belt fears, and believes, that the potential magnitude of the increase will result in the following:

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(1) the transfer of all or a significant portion of the increased cost to end users, including Black Belt, which will have a direct effect on our costs, leading in turn to higher prices for natural gas service for our consumers and a negative impact on the local economy, and potentially making gas prepayment transactions uneconomic for us;

(2) increased pressure on banking organizations to collect margin from end users or submit transactions to exchanges for clearing, notwithstanding the hard-fought efforts by end users, including Black Belt, to be exempt from mandatory margin and clearing requirements; and

(3) a decrease in the overall liquidity in the natural gas derivatives markets, as some banking organizations may choose to exit the market due to higher transaction costs, resulting in increased concentration risk and the lack of access to unique transactions such as gas prepayments and their customized commodity swaps.

3. Black Belt Energy End User Perspective

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In sum, we are concerned that significant capital requirements for commodity transactions with end users, including municipalities, may significantly affect the ability of municipal organizations such as Black Belt to obtain reliable access to natural gas supplies through gas prepayment transactions, as well

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as frustrate the policy goals of exempting end users, including municipalities, from mandatory clearing and margin requirements, and ultimately result in increased costs to the consumer.

4. Summary of SA-CCR Issues for End Users

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As proposed, SA-CCR would penalize large banks' derivative contracts with end users, thereby indirectly penalizing end users themselves, because SA-CCR:

- penalizes un-margined derivatives (even when they are un-margined pursuant to a statutory or regulatory exemption);
- imposes high supervisory factors on commodity transactions in which many end users are active; and
- disregards non-margin forms of credit support like liens and letters of credit and investment grade (including high investment grade) credit ratings.

If adopted in its current form. SA-CCR would substantially increase large banks' capital requirements related to derivatives with end users, impairing end users' access to hedging and risk mitigation practices that the existing, Congressionally-determined margin and clearing exemptions were designed to facilitate.

End users, including municipalities and other governmental entities like Black Belt, are generally exempted from regulatory margin requirements. SA-CCR penalizes counterparty relationships which do not have initial or variation margin. Physically settled forward contracts are not "Swaps" as defined in Title VII of the Dodd-Frank Act, and thus Congress has not made them subject to the mandatory clearing requirement of Title VII. In the margin rulemaking, the Prudential Regulators, the SEC and the CFTC

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SA-CCR does not recognize non-margin forms of collateralization commonly used by end users in lieu of initial or variation margin, including providing banking organizations with liens on physical assets and letters of credit that mitigate the banking organization's credit exposure in the event of counterparty default. Notwithstanding regulatory margin exemptions, there are a variety of credit risk mitigation techniques used when facing end users. Letters of credit probably should be treated as the equivalent of cash collateral. Letters of credit accomplish their purpose by substituting the credit of a bank for that of the customer. The beneficiary is entitled to payment by the issuing bank within a very short time period as long as the beneficiary can provide the documentary evidence required by the letter of credit.

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In addition, a banking organization's risk management decision to leave an end user derivative exposure uncollateralized – neither collecting initial or variation margin, nor receiving non-margin forms of collateralization – is strongly influenced by whether the end user is an investment grade credit, and the proposed rule does not vary SA-CCR weights based on credit rating status. For non-collateralized

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derivative exposures, credit rating status is a key consideration, as is the quality or level of the investment grade rating (A versus BBB, for example).

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The proposal itself acknowledges the negative impact it will have on the ability of commercial end users, including municipalities, to hedge their risk:

> *"In contrast, exposure amounts would increase for derivative contracts with … sovereigns and municipalities; and commercial entities that use derivative contracts to hedge commercial risk." 83 Fed. Reg. 64685, Column 2*

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(1) the transfer of all or a significant portion of the increased cost to end users, including Black Belt, which will have a direct effect on our costs, leading in turn to higher prices for natural gas service for our consumers and a negative impact on the local economy, and potentially making gas prepayment transactions uneconomic for us;

(2) increased pressure on banking organizations to collect margin from end users or submit transactions to exchanges for clearing, notwithstanding the hard-fought efforts by end users, including Black Belt, to be exempt from mandatory margin and clearing requirements; and

(3) a decrease in the overall liquidity in the natural gas derivatives markets, as some banking organizations may choose to exit the market due to higher transaction costs, resulting in increased concentration risk and the lack of access to unique transactions such as gas prepayments and their customized commodity swaps.

3. Black Belt Energy End User Perspective

SA-CCR proposes increases in capitalization requirements that will increase the cost of doing business for banks participating in the natural gas markets as prepaid gas suppliers and as commodity swap counterparties. This would have the result of increasing the cost of natural gas prepayments for Black Belt and therefore for consumers served by our municipal gas system customers. The economics of gas prepayments in the marketplace that have prevailed over the last several years make the successful completion of such projects difficult. Any increase in the cost to prepaid gas suppliers of providing the supply and/or on counterparties to participate in matched commodity swaps has a negative effect on our ability to close them. We fear that the SA-CCR could convince some banks to withdraw from the physical gas markets and commodity swap markets as it becomes more difficult to operate profitably. A reduction in the number of prepaid gas suppliers in the market will be detrimental to municipal gas systems.

In sum, we are concerned that significant capital requirements for commodity transactions with end users, including municipalities, may significantly affect the ability of municipal organizations such as Black Belt to obtain reliable access to natural gas supplies through gas prepayment transactions, as well as frustrate the policy goals of exempting end users, including municipalities, from mandatory clearing and margin requirements, and ultimately result in increased costs to the consumer.

4. Summary of SA-CCR Issues for End Users

Large banks that face end users as counterparties in derivative transactions are subject to capital requirements imposed by the Federal Reserve. Generally speaking, increases in a bank's capital requirements for a given transaction result in higher pricing for the bank's counterparties. At present, banks' capital requirements include a derivatives counterparty credit risk component called the "Current Exposure Method" or "CEM". The Prudential Regulators have proposed to replace CEM with the new SA-CCR exposure methodology.

As proposed, SA-CCR would penalize large banks' derivative contracts with end users, thereby indirectly penalizing end users themselves, because SA-CCR:

- penalizes un-margined derivatives (even when they are un-margined pursuant to a statutory or regulatory exemption);
- imposes high supervisory factors on commodity transactions in which many end users are active; and
- disregards non-margin forms of credit support like liens and letters of credit and investment grade (including high investment grade) credit ratings.

If adopted in its current form. SA-CCR would substantially increase large banks' capital requirements related to derivatives with end users, impairing end users' access to hedging and risk mitigation practices that the existing, Congressionally-determined margin and clearing exemptions were designed to facilitate.

End users, including municipalities and other governmental entities like Black Belt, are generally exempted from regulatory margin requirements. SA-CCR penalizes counterparty relationships which do not have initial or variation margin. Physically settled forward contracts are not "Swaps" as defined in Title VII of the Dodd-Frank Act, and thus Congress has not made them subject to the mandatory clearing requirement of Title VII. In the margin rulemaking, the Prudential Regulators, the SEC and the CFTC specifically exempted end users from margin requirements, following the Commodities Exchange Act's exemption of end users from mandatory clearing. SA-CCR will frustrate these policy-based exclusions and exemptions if end users are unable to access derivatives markets or have to bear increased costs to enter into derivatives transactions because of increased margin requirements imposed on their end user counterparties.

SA-CCR does not recognize non-margin forms of collateralization commonly used by end users in lieu of initial or variation margin, including providing banking organizations with liens on physical assets and letters of credit that mitigate the banking organization's credit exposure in the event of counterparty default. Notwithstanding regulatory margin exemptions, there are a variety of credit risk mitigation techniques used when facing end users. Letters of credit probably should be treated as the equivalent of cash collateral. Letters of credit accomplish their purpose by substituting the credit of a bank for that of the customer. The beneficiary is entitled to payment by the issuing bank within a very short time period as long as the beneficiary can provide the documentary evidence required by the letter of credit.

Liens on physical assets, such as oil and gas reserves, are a form of credit risk mitigation that can be used. For example, an oil or gas producer may grant a lien on its reserves as collateral for its hedges of its inventories that it anticipates selling in the future. When oil or natural gas prices rise, the banking organization has credit exposure to the producer, but in these circumstances, the producer's future sales of the commodity will be profitable. When oil or natural gas prices drop, the banking organization has no exposure to the producer because the banking organization owes the producer on the hedge.

In addition, a banking organization's risk management decision to leave an end user derivative exposure uncollateralized – neither collecting initial or variation margin, nor receiving non-margin forms of collateralization – is strongly influenced by whether the end user is an investment grade credit, and the proposed rule does not vary SA-CCR weights based on credit rating status. For non-collateralized

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derivative exposures, credit rating status is a key consideration, as is the quality or level of the investment grade rating (A versus BBB, for example).

End users often have directional portfolios, which are penalized by SA-CCR, even though a directional derivatives portfolio may be necessary to hedge an underlying non-derivative directional exposure of the end user, meaning that a directional derivatives portfolio typically involves right-way risk.

End users heavily rely on the ability to enter into financially and physically settled transactions in commodities, particularly in the energy sector, which are subject to relatively high SA-CCR supervisory factors. Application of a 40 percent supervisory factor to end users with electricity, oil and natural gas exposures is not representative of the banking organization's underlying credit risk to end users.

Moreover, applying the same supervisory factor for electricity, oil and natural gas does not recognize the different degrees of volatility of these asset groups. Oil and natural gas, which can be stored, are inherently less volatile than electricity.

While electricity prices can be volatile in the spot month, applying a supervisory factor of 40 to electricity is not consistent with the lower degree of volatility in electricity prices in the forward curve, where credit risk to counterparties is relevant. The same is true for natural gas, where the volatility of the forward curve over one, two, or three years is significantly less, and far more relevant, than the spot or prompt month forward curve.

These extremely high supervisory factors for energy transactions will create a punitive impact on the ability of these end users to hedge their risks in these assets and obtain reliable supplies of energy commodities, with the ultimate increase in costs borne by the consumer.

The proposal itself acknowledges the negative impact it will have on the ability of commercial end users, including municipalities, to hedge their risk:

> *"In contrast, exposure amounts would increase for derivative contracts with … sovereigns and municipalities; and commercial entities that use derivative contracts to hedge commercial risk." 83 Fed. Reg. 64685, Column 2*

5. Conclusion

For the foregoing reasons, Black Belt respectfully requests that the proposed SA-CCR NOPR should not be applied to banks' commodities transaction with end users, particularly governmental end users such as Black Belt who utilize gas supply contracts and commodity swap transactions in the natural gas industry for long-term supply reliability, price competitiveness, and price protection for the consumers they serve.

Respectfully submitted,

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