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Via Electronic Submission

Board of Governors of the Federal Reserve System
Ann E. Misback, Secretary
20th Street and Constitution Ave. NW
Washington, DC 20551

Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
400 7th Street SW, Suite 3E–218
Washington, D.C. 20219

Federal Deposit Insurance Corporation
Robert E. Feldman, Executive Secretary
550 17th Street NW
Washington, D.C. 20429

RE: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts
Docket R-1629 and RIN 7100–AF22; Docket ID OCC–2018–0030; RIN 3064-AE80
Comments of the Joint Associations

I. Introduction

The American Gas Association ("AGA"),[1] American Public Power Association ("APPA"),[2] American Wind Energy Association ("AWEA"),[3] Edison Electric Institute ("EEI"),[4]

[1] AGA, founded in 1918, represents more than 200 local energy companies that deliver clean natural gas throughout the United States. There are more than 74 million residential, commercial and industrial natural gas customers in the U.S., of which 95 percent — more than 71 million customers — receive their gas from AGA members. Today, natural gas meets more than one-fourth of the United States' energy needs.

[2] APPA is the national service organization representing the interests of government-owned electric utilities in the United States. More than 2000 government-owned electric systems provide over 15 percent of all kilowatt-hour sales to ultimate electric customers. APPA's member utilities are not-for-profit utility systems that were created by state or local governments to serve the public interest. Some government-owned electric utilities generate, transmit, and sell power at wholesale and retail, while others purchase power and distribute it to retail customers, and still

Electric Power Supply Association ("EPSA")[5] and National Rural Electric Cooperative Association ("NRECA")[6] (hereafter "Joint Associations") respectfully submit these comments in response to the Notice of Proposed Rulemaking ("NOPR" or "Proposed Rule") issued by the Board of Governors of the Federal Reserve System (the "Board"), the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (collectively, the "Prudential Regulators"), proposing to implement a new approach for calculating the exposure amount of derivative contracts under the Prudential Regulators' capital rules.[7] The Joint Associations appreciate the opportunity to comment on the Proposed Rule and to highlight the importance of robust, liquid physical energy commodity and commodity derivatives markets to the commercial energy industry.[8]

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others perform all or a combination of these functions. Government-owned utilities are accountable to elected and/or appointed officials and, ultimately, the American public. The focus of a government-owned electric utility is to provide reliable and safe electricity service, keeping costs low and predictable for its customers, while practicing good environmental stewardship.

[3] AWEA is the national trade association representing a broad range of entities with a common interest in encouraging the deployment and expansion of wind energy resources in the United States. AWEA members include wind turbine manufacturers, component suppliers, project developers, project owners, financiers, researchers, renewable energy supporters, utilities, marketers, customers and their advocates.

[4] EEI is the association that represents all U.S. investor-owned electric companies. Our members provide electricity for about 220 million Americans and operate in all 50 states and the District of Columbia. As a whole, the electric power industry supports more than 7 million jobs in communities across the United States. EEI's members are committed to providing affordable and reliable electricity to customers now and in the future.

[5] Launched over 20 years ago, EPSA is the national trade association representing leading independent power producers and marketers. EPSA members provide reliable and competitively priced electricity from environmentally responsible facilities using a diverse mix of fuels and technologies. Power supplied on a competitive basis collectively accounts for 40 percent of the U.S. installed generating capacity. EPSA seeks to bring the benefits of competition to all power customers. The comments contained in this filing represent the position of EPSA as an organization, but not necessarily the views of any particular member with respect to any issue.

[6] 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.

[7] *Standardized Approach for Calculating the Exposure Amount of Derivative Contracts*, Notice of Proposed Rulemaking, 83 Fed. Reg. 64661 (December 17, 2018).

[8] EEI and NRECA expressed their concerns to the Prudential Regulators on proposed capital requirements for "Covered Swap Entities," including banking organizations that are registered "swap dealers," as such term is defined in the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010) (the "Dodd-Frank Act") in comments on the proposed rule on *Margin and Capital Requirements for Covered Swap Entities* (RIN 1557-AD43, 7100-AD74, 3064-AD79, 3052-AC69, 2590-AA45), 76 Fed. Reg. 27564 (May 11, 2011). A copy of the 2011 Comment Letter is found here: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47751&SearchText. In addition, EEI and NRECA expressed their concerns to the Board on its recent proposal to increase risk-based capital requirements for bank holding companies and financial holding companies that enter into physical energy commodity transactions in comments on *Risk-based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities…*, 81 Fed. Reg. 67220 (September 30, 2016). A copy of the 2017 Comment Letter is found here: https://www.federalreserve.gov/secrs/2017/february/20170223/r-1547/r-1547_022017_131746_434839562509_1.pdf. Because the Proposed Rule would affect all banking organizations (not just registered swap dealers) and all of a banking organization's derivative contracts, including "swaps" as well as other commodity transactions that are excluded or exempted from the defined term "swap," such as physical

Banking organizations subject to the Prudential Regulators' jurisdiction are required to maintain certain threshold amounts of capital against their exposure on derivative contracts[9] based on the credit risk of counterparties (i.e., the default risk). This includes taking into consideration a supervisory factor that reflects the potential volatility in the trading markets for the commodity, rate or other measure underlying or referenced by the asset class or category of derivative contracts. Currently, banking organizations calculate the credit risk of exposures using the current exposure methodology ("CEM") or, if the banking organization is over a certain size and maintains internal risk models reviewed by its principal Prudential Regulator, such as larger banking organizations, may use an internal model methodology to risk-weight the exposure amounts. However, those larger banking organizations must nonetheless use an adjusted CEM approach to measure the bank's leverage ratio and maintain a minimum level of regulatory capital based on such ratio.[10]

In the NOPR, the Prudential Regulators have proposed a new methodology for measuring counterparty credit risk known as the "Standardized Approach for Counterparty Credit Risk" or "SA-CCR." The Proposed Rule indicates that the SA-CCR methodology is intended to improve collateral recognition in measuring credit risk, and to better capture stress volatilities observed in certain commodity trading markets during the financial crisis to reduce the risk associated with derivative contracts.[11] However, the Proposed Rule is inconsistent with Congressional intent and the Prudential Regulators' rules implementing the Dodd-Frank Act. The likely result of the proposed change in the regulatory capital is that banking organizations will need to maintain substantially higher amounts of regulatory capital for bilateral noncleared energy commodity derivative contracts with commercial end-users, including the Joint Association members.

The Joint Associations' members are not financial entities. Rather, they are physical commodity market participants that rely on derivative contracts, specifically financially-settled commodity swaps and customized bilateral forward contracts for energy commodities such as natural gas and electricity delivered into regional geographic markets, to supply customers with reliable energy services and to hedge or mitigate commercial risks arising from ongoing business operations. Regulations that make effective commercial risk management more expensive for commercial end-users in the energy industry will likely lead to higher energy prices if the costs

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commodity forward contracts and commodity trade options, the Joint Associations incorporate by reference these two prior comment letters.

[9] The NOPR explains that a "derivative contract" represents, in general, an agreement between parties "either to make or receive payments ***or to buy or sell an underlying asset*** on a certain date (or dates) in the future." 83 Fed Reg. 64663 (*emphasis added*). Thus, the Proposed Rule is intended to apply the new SA-CCR methodology to measure credit risk of exposures under "swaps," as such term is defined in the Dodd-Frank Act amendments to the Commodity Exchange Act (the "CEA") and under other "derivative contracts" that are excluded or exempted from the defined term "swap" under the CEA or under the rules, interpretations and exemptive orders published by the Commodity Futures Trading Commission (the "CFTC"), including nonfinancial commodity forward contracts and commodity trade options.

[10] The NOPR comments that the last significant update to CEM was in 1995 and, as a result, CEM does not reflect recent market conventions and regulatory requirements that are designed to reduce the risks associated with derivative contracts (83 Fed. Reg. at 64665), referencing the Prudential Regulators' Final Rule on *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74840 (November 30, 2015) (the "Swap Margin and Capital Rule").

[11] 83 Fed. Reg. at 64665-64666.

associated with new regulatory capital rules are passed through to residential, commercial and industrial energy consumers, or will result in more volatile energy prices for consumers if commercial end-users are unable to cost-effectively hedge, and therefore hedge a smaller portion of, the commercial risks arising from ongoing operations.

Since 2003, participation by banking organizations in the U.S. energy commodity markets has enhanced market liquidity, particularly in the energy commodity categories and regional geographic markets that are important for utilities to supply customers with affordable and reliable energy services. The Joint Associations' members rely on such banking organizations as creditworthy counterparties to long-term, customized energy commodity derivative contracts. Banking organizations also participate in electricity markets operated by regional transmission organizations and independent system operators, and offer bilateral over-the-counter energy commodity swaps customized for regional market characteristics. 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, as proposed, the Proposed Rule will significantly increase a banking organization's capital requirements for energy commodity derivative contracts with commercial end-user counterparties, such as the Joint Associations' members.[12] This would indirectly raise costs for our members, as the banking organizations seek to pass on the increased regulatory capital costs. The increased capital requirements will also likely decrease the overall liquidity in the markets for energy commodity derivatives, as banking organizations may choose not to engage in the markets for some or all of these energy commodity derivative contracts due to the higher costs. The Joint Associations' members need liquid, efficient, and competitive physical energy commodity and derivatives markets to hedge commercial risks of ongoing operations.

The Proposed Rule is inconsistent with the Dodd-Frank Act and implementing regulations, and the Joint Associations respectfully request the Prudential Regulators to consider the potential negative impact of the Proposed Rule on physical energy commodity market participants, including the members of the Joint Associations. Specifically, the Joint Associations request that the Prudential Regulators not apply this new SA-CCR methodology or the significant supervisory factor in the Proposed Rule to measure credit risk of a banking organization's exposure to noncleared derivative contracts where the counterparty is a commercial end-user. Such derivative contracts should be considered under another methodology and, in particular, larger banking organizations should be allowed to use internal

[12] The NOPR explains that, based on data provided by larger banking organizations, the Proposed Rule would increase the exposure amount of unmargined derivative contracts for banking organizations by approximately 90%, a significant increase in the aggregate, requiring substantial new regulatory capital. The NOPR also identifies the disproportionate effect of these increases on banking organizations that enter into derivative contracts referencing physical commodities and derivative contracts with commercial end-user counterparties, but does not attempt to quantify, explain or justify this disproportionate, burdensome effect on commercial end-users. "The agencies also analyzed the changes based on both asset classes and counterparties for these firms. With respect to asset classes,…the exposure amount would increase for…commodity derivative contracts…largely due to the updated supervisory factors…and 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. at 64685.

models and to mitigate credit risk by other means within the overall commercial counterparty relationship. In the world of bilateral swaps, commodity forward contracts and other customary commercial arrangements, the counterparty's identity is known and critical to the credit risk analysis.

II. Proposed Rule

The Prudential Regulators require banking organizations under their supervisory authority to maintain certain threshold amounts of regulatory capital against their exposure to credit risk under derivative contracts to the potential that the counterparty will default on its obligations and fail to pay the amount owed under the derivative contract.

The new SA-CCR methodology assigns a lower risk weighting to a banking organization's noncleared derivative contracts that are collateralized with cash (initial and variation) margin. This methodology is consistent with the way the Prudential Regulators evaluate the risks of standardized trading instruments, including securities and exchange-traded futures contracts, where such derivative contracts are cleared and cash margined, and the counterparty to the trading instrument is anonymous. However, not all "derivative contracts" are trading instruments and not all derivative contracts are traded or standardized enough to be tradeable on an exchange. Not all derivative contracts are cleared, accepted for clearing by a central clearing party, or required to be cleared. A transaction-only-based credit risk methodology like SA-CCR may be appropriate for trading instruments, but is not appropriate for assessing credit risk associated with customized and noncleared bilateral derivative contracts, where the counterparty's identity is known and the banking organization can conduct due diligence and evaluate its exposure and its credit risk based on its overall relationship with the counterparty.

The new SA-CCR methodology fails to appropriately recognize the risk-reducing characteristics of non-cash collateral that is typically exchanged between banking organizations and commercial end-user counterparties, as well as credit support other than collateral that is typically posted by counterparties in the energy industry and other commercial industries. The SA-CCR methodology also fails to appropriately recognize that it is common for some banking organizations to have exposure under energy commodity derivative contracts, such as over-the-counter commodity swaps and commodity forward contracts to which commercial market participants are parties, where the exposures are unsecured or secured only if aggregate and netted exposures between two counterparties exceed certain thresholds. The banking organization makes an individual counterparty "credit risk" evaluation and may decide to allow unsecured credit exposure based on counterparty credit ratings, "right-way risk" aspects of the counterparty's physical commodity operations, or other creditworthiness characteristics and metrics based on the overall counterparty/bank customer relationship.

The Proposed Rule introduces "updated" supervisory factors (substantially increasing the risk weighting) for exposure under derivative contracts referencing several categories of physical commodities, with the highest supervisory factor for a single category of energy commodities, including crude oil, natural gas and electricity. This significant supervisory factor for derivatives contracts referencing energy commodities is explained in the NOPR as reflecting "stress

volatilities observed during the financial crisis,"[13] with little additional explanation. This single "super risk-weighting" for all energy commodity derivative contracts groups together very different commodities that trade in many different global and regional geographic markets, with very different volatilities in the spot month and at various points out on the forward curves. The NOPR does not explain its analysis of volatility data or how it calibrated the supervisory factor, nor does the NOPR justify the substantial negative impact of the Proposed Rule on commercial end-users in the energy industry.[14]

III. Comments on Proposed Rule

A. The Proposed Rule is Inconsistent with U.S. Government Policy, as Reflected in the Dodd-Frank Act and Implementing Regulations, and Should be Revised to Exclude Exposures on Noncleared Derivative Contracts to Which Commercial End-Users are Counterparties.

As part of the global policymakers' response to the 2008-2009 financial markets crisis, Title VII of the Dodd-Frank Act authorized the US regulators to impose clearing and trade execution requirements on standardized "swaps,"[15] with one important exception. Section 2(h)(7) of the CEA, as amended by Section 723(a)(3) of the Dodd-Frank Act, excepts from the clearing and exchange-trading requirements any swap entered into by a non-financial entity to hedge or mitigate commercial risks. The Dodd-Frank Act also authorized the Prudential Regulators and the CFTC to regulate "swap dealers"[16] and, in doing so, to establish margin and capital requirements for noncleared swaps entered into by swap dealers as part of swap dealing activities, in order "[t]o offset the greater risk to the swap dealer…and the financial system arising from the use of swaps that are not cleared."[17] In particular, CEA Section 4s(e)(2)(A) authorizes the Prudential Regulators to adopt such margin and capital requirements for banks that are registered swap dealers, and CEA Section 4s(e)(2)(B) authorizes the CFTC to adopt such margin and capital requirements for registered swap dealers that are not banks.[18] CEA Section 4s(e)(3)(D) provides that the Prudential Regulators and the CFTC must periodically consult on capital and margin rules, and establish and maintain capital and margin requirements, including

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[13] *See* 83 Fed. Reg. 64666.

[14] See the analysis of the Impact of the Proposed Rule, 83 Fed. Reg. 64685.

[15] See fn 9 for an explanation of the distinction between the term "derivative contract," as used in the Proposed Rule, and the term "swap," as defined in the Dodd-Frank Act and the CFTC's rules, interpretations and exemption orders. In the Dodd-Frank Act, Congress focused on mitigating the risks to the swap dealer and to the financial system associated with noncleared "swaps" entered into as part of dealing activity. However, Congress concurrently recognized that some swaps, such as customized bilateral commodity swaps, may not be standardized enough to be cleared or to be required to trade on an exchange. The CFTC has put in place a process, subject to notice and comment, by which it determines which category or type of swap is sufficiently standardized to impose a clearing mandate, and also determines if a swap is sufficiently made available to trade on an exchange such that it must be traded on an exchange. To date, there are no CFTC clearing mandates or trading requirements for physical commodity swaps.

[16] CEA Section 4s.

[17] CEA Section 4s(e)(3)(A).

[18] CEA Section 4s(e)(3)(A)-(B).

the use of non-cash collateral, applicable to swap dealers under their respective jurisdiction that are comparable to the maximum extent practicable.[19]

Notably, the Dodd-Frank Act does not authorize the Prudential Regulators or the CFTC to adopt margin and capital requirements that apply to all banking organizations, or to all banking organizations that enter into "swaps," or to all "swaps" to which a banking organization has exposure.[20] In a joint rulemaking with the Securities and Exchange Commission and in consultation with the Prudential Regulators, the CFTC defined "swap dealer" to recognize that some noncleared swaps may not be part of "a regular business of swap dealing" (and so may not be subject to margin and capital rules), and also allowed an entity to enter into a de minimis threshold amount of dealing swaps before being required to register and be regulated as a swap dealer to which the Dodd-Frank Act regulatory margin and capital rules for noncleared swaps apply.[21]

In the legislative history of the Dodd-Frank Act, Congress made it clear that it did not intend regulators to restrict or burden the ability of commercial end-users to enter into swaps to hedge or mitigate commercial risks arising from ongoing operations.[22] The Prudential Regulators' final Dodd-Frank Act margin and capital rules for swap dealers, published in late 2015, were consistent with this Congressional intent. The Final Swap Margin and Capital Rules did not impose regulatory margin or capital requirements for a swap dealer's noncleared swaps with commercial end-user counterparties.[23] In the Final Swap Margin and Capital Rules, the Prudential Regulators made it clear that swap dealers are not required to maintain or post cash initial or variation margin with counterparties that are not "financial end-users." "For other counterparties [i.e., for nonfinancial end-users], the final rule directs covered swap entities to collect margin at such times and in such forms and amounts (if any**)** that the covered swap entity determines appropriately addresses the credit risk posed by the counterparty and the risks of such swaps." See 80 Fed. Reg. at 74865-866 (*emphasis added*).

In the adopting release for the Final Swap Margin and Capital Rules, the Prudential Regulators also explained why they did not impose specific regulatory capital requirements relating to a swap dealer's exposure to noncleared swaps. The adopting release discussed the improvements that had been made to regulatory capital rules in the aftermath of the 2008-2009 financial crisis, and concluded that "[g]iven that the[se] existing regulatory capital rules

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[19] CEA Section 4s(e)(3)(D).

[20] Nothing in the Dodd-Frank Act requires regulatory margin or capital requirements for "derivative contracts" that are not "swaps," such as nonfinancial commodity forward transactions that are excluded from the definition under CEA 1a(47)(b)(ii), or other commodity contracts or transactions that are excluded or exempted under CFTC rules, interpretations and orders.

[21] *Further Definition of ''Swap Dealer,'''''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant,''* 75 Fed. Reg. 80174 (Dec. 21, 2010).

[22] *See* 156 Cong. Rec. H52248. Letter from Senator Christopher Dodd and Senator Blanche Lincoln to the Honorable Barney Frank and the Honorable Colin Peterson. (June 30, 2010).

[23] The NOPR comments that the changes in the Proposed Rule are intended to be consistent with the Final Swap Margin and Capital Rule, see 83 Fed. Reg.64665 at fn 22. However, the changes are directly inconsistent with the Final Swap and Margin Rule in that the Proposed Rule would impose cash margin requirements or require regulatory capital for noncleared derivatives contracts, including swaps, with counterparties that are commercial end-users (i.e., that are not "financial end-users" as that term is used in the Final Swap Margin and Capital Rule).

specifically take into account and address the unique risks arising from swap transactions and activities, the Agencies will rely on these existing rules as appropriate and sufficient to offset the greater risk to the covered swap entity and the financial system arising from the use of swaps that are not cleared and to protect the safety and soundness of the covered swap entity."[24]

Despite these clear policy statements when adopting the Final Swap Margin and Capital Rule, the Proposed Rule would radically change the Prudential Regulators' policy approach to derivative contracts to which commercial end-users are counterparties. The Proposed Rule would impose broad and burdensome regulatory capital requirements for all banking organizations and for exposure under all noncleared derivative contracts, including noncleared swaps and nonfinancial commodity forward contracts and other derivative contracts that are excluded or exempted from the defined term "swap." Although the Prudential Regulators articulated the policy reasons for exempting swap dealers from cash margin requirements for swaps with commercial end-users in the Final Swap Capital and Margin Rule, the Proposed Rule would disregard those determinations and require a banking organization to maintain regulatory capital unless it required cash margin for all derivative contracts, regardless of the counterparty's identity.[25]

Thus, if adopted as proposed, Joint Associations are concerned that the Proposed Rule would force banking organization counterparties to pass-through increased capital requirements to their commercial end-user counterparties in the form of higher transaction fees, or to leave the markets for commodity derivatives which would result in less liquid markets. Banks may also seek to avoid the higher capital charges imposed by SA-CCR by requiring commercial end-users to post cash margin, which would frustrate Congressional intent to exempt commercial end-users from regulatory margin requirements for swaps.[26]

As such, the Joint Associations respectfully request that the Prudential Regulators reconsider the proposed definitions, metrics and analysis for applying SA-CCR to calculate counterparty credit risk of a banking organization's noncleared derivative contracts. Specifically, the Prudential Regulators should exclude from the regulatory capital calculations noncleared derivative contracts between a banking organization and a nonfinancial end-user counterparty. This will help ensure that the SA-CCR proposal aligns with the exclusions, exemptions and other regulatory accommodations that nonfinancial (commercial) end-users have been granted under the Dodd Frank Act and regulations implementing that law.

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[24] *See* 80 Fed. Reg at 74846-47.

[25] This is the effective result even if the banking organization holds other forms of collateral or credit support to manage the credit risk, or exercised its credit risk judgment not to secure its exposure, or part of its exposure, to a particular commercial end-user counterparty

[26] As policymakers have acknowledged since the Dodd-Frank Act was enacted in 2010, "[r]egulators…must not make hedging so costly it becomes prohibitively expensive for end users to manage their risk….Congress clearly stated in this bill [the Dodd-Frank Act] that the margin and capital requirements are not to be imposed on end users, nor can the regulators require clearing for end user trades. Regulators are charged with establishing rules for the capital requirements, as well as the margin requirements for all uncleared trades, but ...Capital and margin standards should be set to mitigate risk in our financial system, not punish those who are trying to hedge their own commercial risk." See Dodd-Lincoln Letter, supra at fn 22, at 2.

B. Alternatively, the Prudential Regulators Should Allow the Use of a Wide Variety of Non-Cash Collateral and other Forms of Credit Support, As Well as Unsecured Credit for Commercial End-User Counterparties

If the Prudential Regulators do not revise the Proposed Rule as requested in A. above, then SA-CCR should be amended to recognize the credit risk mitigation effects of non-cash collateral and other credit risk mitigation methodologies commonly used by banking organizations with their nonfinancial end-user counterparties. Such a revision would be consistent with the Dodd-Frank Act and implementing regulations. The Dodd-Frank Act included new CEA Section 4s(e)(3)(C) provides that "[i]n prescribing margin requirements . . . the prudential regulator . . . shall permit the use of noncash collateral, as [it]. . . determines to be consistent with . . . (i) preserving the financial integrity of markets trading swaps; and (ii) preserving the stability of the United States financial system."[27] The SA-CCR methodology in the Proposed Rule does not recognize the credit risk mitigation effects of non-margin forms of collateralization commonly used by commercial end-users, including providing banking organizations with liens on physical assets, or other forms of credit support such as guaranties or letters of credit that mitigate the banking organization's credit risk exposure. This omission overstates the actual credit risk to which banking organizations are exposed, thereby unnecessarily and inappropriately increasing their costs with associated negative impacts on the markets in which they transact. Any requirement that non-financial end-users post substantial cash margin as collateral for commodity derivative contracts would harm market liquidity and significantly impair non-financial end-user's ability to efficiently deploy capital and hedge commercial risks.

Commercial end-users generally do not post cash margin for commodity derivative contracts other than futures contracts, as it is often prohibitively expensive and ties up cash and working capital that can more appropriately be used to invest in the commercial end-user's capital projects or for other operational uses. Allowing banking organizations to continue to accept non-cash collateral recognizes these capital and cash management inefficiencies for non-financial businesses. Similarly, guaranties and letters of credit should be treated as the equivalent of cash collateral in terms of their ability to mitigate credit risk. Guaranties from creditworthy entities and letters of credit accomplish their purpose by substituting the credit of the guarantor or issuing bank for that of the counterparty. The beneficiary is entitled to payment by the guarantor or issuing bank within a very short time period as long as the beneficiary can provide the documentary evidence of the counterparty's default.

In addition, the Proposed Rule does not allow banking organizations to take a counterparty's credit rating or other creditworthiness characteristics or metrics into consideration when determining the most appropriate way to manage counterparty credit risk. This is an important credit risk mitigation factor used by banks today in determining whether to require any collateral or other forms of credit support, or to leave the banking organization's exposure to credit risk of an identified counterparty default wholly or partially uncollateralized.

[27] CEA Section 4s(e)(3)(C).

C. Alternatively, the Supervisory Factor Applied to Derivative Contracts Referencing Energy Commodities Should be Substantially Reduced, Particularly for Derivative Contracts with Commercial End-User Counterparties

If the Prudential Regulators do not revise the Proposed Rule as requested in A. above, then the supervisory factors applied to derivative contracts referencing energy commodities should be eliminated or substantially reduced for derivative contracts with commercial end-user counterparties. Commercial end-users in the energy industry, such as the Joint Associations' members, rely on the ability to enter into noncleared derivative contracts referencing energy and other physical commodities as an asset class to hedge commercial risks of ongoing operations. The most significant new supervisory factor in the Proposed Rule is applicable to derivative contracts referencing electricity, oil and natural gas commodities. This supervisory factor is not representative of a banking organization's credit risk for noncleared commodity derivative contracts with commercial end-user counterparties.[28] The supervisory factor for energy commodities means the Proposed Rule will impose the most substantial burdens on commercial end-users that use customized, noncleared and nonmargined energy commodity derivatives contracts to hedge commercial risks arising from ongoing energy industry operations.

In addition, the Joint Associations respectfully request that the Prudential Regulators explain the analytical basis for the disproportionately high supervisory factor for energy commodity derivative contracts, and the reasoning for utilizing the same "super" supervisory factor for derivative contracts referencing electricity, oil and natural gas commodities.[29] The supervisory factor should be calibrated on a more granular level to recognize the very different characteristics of these commodities which may affect trading market volatility for different energy commodities deliverable in various geographic regions. For example, natural gas and oil can be stored, while electricity cannot be stored in commercial quantities. Regional weather conditions affecting supply and demand for certain commodities during particular time periods differ and, while pricing of energy commodities may be volatile in the spot month (more in some markets and less in others), pricing further out the forward curve is less volatile. Without an analysis of the differing volatilities in the spot, forward and long-forward markets for each of these commodities, a single, disproportionately high supervisory factor is not appropriate to measure forward credit risk exposure. Moreover, applying a supervisory factor of 40 to natural gas/oil is not justified in the Proposed Rule in light of the physical and market characteristics of the commodities and the proposed level is inconsistent with that used by other banking authorities.[30]

Finally, as discussed earlier, trading market volatilities are not an appropriate proxy for forward credit risk, particularly where the counterparty is a commercial end-user hedging commercial risks of ongoing operations. Commercial end-user counterparties in the energy industry own long-term energy commodity assets and have ongoing energy commodity needs to

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[28] The Prudential Regulators recognized this lesser credit risk of commercial end-user counterparty default in the Final Swap Margin and Capital Rule at 88 Fed. Reg. 74853-74856 and again at 74867.

[29] *See* Basel Committee on Banking Supervision: The standardized approach for measuring counterparty credit risk exposures (Revised April 2014) at p. 19, available at https://www.bis.org/publ/bcbs279.pdf (the supervisory factors for electricity and oil/gas are different) ("Basel Committee 2014 Standards").

[30] *See* Basel Committee 2014 Standards at p. 19 (oil/gas commodity supervisory factor is 18%).

hedge, and therefore are less likely than financial trading counterparties to represent a credit (default) risk, including during periods of financial stress.[31]

The NOPR acknowledges that the impact of the Proposed Rule changes varies by asset class, and that exposure amounts (and regulatory capital requirements) will increase for commodity derivative contracts "largely due to the updated supervisory factors, which reflect stress volatilities observed during the financial crisis."[32] If, as the Prudential Regulators found in the Final Swap Margin and Capital Rules, commercial end-users are less likely than financial trading counterparties to default even in time of financial distress, it is not appropriate to apply the supervisory factors for commodity derivative contracts, including the disproportionately high factor for energy commodities, to noncleared derivative contracts to which the counterparty is a commercial end-user. The calculation, calibration and application of the supervisory factors for commodity derivative contracts should be reviewed and, if necessary, revised to ensure that they are calibrated to volatilities in relevant commodity forward and derivatives markets, to periods of forward risk, not spot risk. The supervisory factors should not be applied, or should be substantially lowered for commodity derivative contracts to which commercial end-users are counterparties, to recognize the much lesser credit risk of counterparty default.

IV. Conclusion

The Joint Associations appreciate the opportunity to submit comments on the Proposed Rule. As discussed above, implementation of the Proposed Rule as drafted would have a substantial, disproportionate and negative impact on liquidity in the energy commodity and derivatives markets and the ability of commercial end-users, including members of the Joint Associations, to find creditworthy counterparties for the energy commodity derivative contracts that they need to cost-effectively hedge or mitigate commercial risks of ongoing operations. As such, the Joint Associations request that the Prudential Regulators reconsider the Proposed Rule to ensure that the Proposed Rule does not undermine the exclusions, exemptions and accommodations that policy-makers, including Congress and the Prudential Regulators, have provided commercial end-users in the Dodd-Frank Act and the regulations promulgated in the aftermath of the financial crisis.

Respectfully submitted,

[31] *See* the Final Swap Margin and Capital Rule at 88 Fed. Reg. 74853-856 and 74867.

[32] 83 Fed. Reg. at 64685.

Matthew J. Agen Assistant General Counsel American Gas Association 400 North Capitol Street, NW Washington, DC 20001 (202) 824-7090 magen@aga.org	Delia D. Patterson SVP Advocacy & Communications and General Counsel American Public Power Association 2451 Crystal Dr., Suite 1000 Arlington, VA 22202 dpatterson@publicpower.org
Amy Farrell Senior Vice President, Government and Public Affairs American Wind Energy Association 1501 M St. NW, Suite 900 Washington, DC 20005 afarrell@awea.org	Lopa Parikh Senior Director, Federal Regulatory Affairs Edison Electric Institute 701 Pennsylvania Avenue, N.W. Washington, D.C. 20004 Email: lparikh@eei.org
/s/Sharon Theodore Sharon Theodore Senior Director, Regulatory Affairs Electric Power Supply Association 1401 New York Ave, NW, 9th Floor Washington, D.C. 20005 stheodore@epsa.org	Russell Wasson Senior Director of Tax, Finance and Accounting Policy National Rural Electric Cooperative Association 4301 Wilson Blvd., EP11-253 Arlington, VA 22203 russell.wasson@nreca.coop