Dear Vice Chair Barr, Chairman Gruenberg, and Acting Comptroller Hsu:

The US economy benefits from having one of the most efficient and productive energy industries in the world. Well-functioning derivatives markets contribute to that success by providing energy producers, refiners, suppliers, and utilities with highly effective tools for managing price risk. This contribution could be threatened, however, by recent proposals to increase bank capital requirements. Those proposals include several provisions that will make it much more expensive for banks to clear derivatives for their clients. We are concerned that this increase in costs will negatively impact our ability to use derivatives to manage our risks.

Energy markets are among the most volatile of all markets in the world. Both supply and demand are subject to sudden shocks, and prices can swing violently from one extreme to another. To protect themselves from this volatility, entities throughout the energy value chain, from oil and gas producers to utilities, participate in the derivatives market to mitigate commercial risk. For producers, a hedging strategy can ensure cost recovery even if prices decline. Moreover, utilities are encouraged to hedge by state and local public utility commissions and boards in order to limit commodity price volatility and protect consumers. Utilities use these hedging strategies to keep the lights and heat on, while maintaining affordability. Similar hedging strategies are employed by manufacturing and transportation companies that use derivatives to protect themselves from volatility in case power or fuel prices suddenly rise.

Futures, options and swaps are the building blocks for this type of risk management. They allow end-users to manage price risk on a wide range of energy commodities, including crude oil, gasoline, heating oil, jet fuel, natural gas and electricity. Most of the risk in the energy derivatives markets is channeled into clearinghouses, also known as central counterparties, through the use of central clearing. But even when an end-user opts out of central clearing, the dealers on the other side of the trade rely on the
centrally cleared markets to hedge their risks. In effect, central clearing provides the foundation for risk transfer in the energy derivatives markets, and by extension, the hedging strategies used by energy producers, refiners and suppliers to protect their businesses from price volatility.

The US Federal Reserve GSIB Surcharge Proposal and the US Basel III Endgame Proposal (collectively, “US Bank Capital Proposals”) will make it more expensive for banks to offer clearing to their customers. Although these proposals are not aimed directly at end-users, we believe that the indirect effects will be substantial. This could make hedging unaffordable for many energy end-users, which would expose them to higher risks. Alternatively, if end-users decide to pay more to hedge, the costs will flow through to their customers in the form of higher energy prices.

The increased costs of client clearing also has the potential to harm end-users by reducing the number of banks willing to provide clearing services to end-users in the energy industry. According to data published by the Commodity Futures Trading Commission, the number of firms that provide clearing for exchange-traded futures and options has fallen by 50% during the past twenty years. Of the 47 firms that currently provide clearing for those products, the majority are banks. The proposed increase in capital requirements for these banks seems likely to lead to further consolidation and fewer choices for end users.

The situation is even more dire in the clearing of over-the-counter derivatives. In 2014, there were twenty-two firms that cleared OTC derivatives for clients. Today, there are only twelve, and the top six in terms of market share are US banks that will be directly affected by the proposed increase in capital requirements. Any proposal that puts further pressure on these firms runs the risk of decreasing the availability of clearing services for derivatives, which will negatively impact end-users.

In short, this is already a fragile ecosystem that’s necessary to manage customer bills. Current hedging activity shifts the financial risk away from the customer and onto commercial participants that can manage that risk utilizing the hedging tools described above. If the US Bank Capital Proposals are implemented, the result will be a decrease in entities offering clearing services, a decrease in liquidity (which will increase volatility), a decrease in hedging, and an increase in costs to customers, who ultimately bear these costs. We urge the US prudential regulators to consider these concerns before finalizing any significant changes to the capital framework.

Sincerely,

Energy Trading Institute
Electric Power Supply Association
American Gas Association
American Public Gas Association
Commodity Markets Council