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Via Electronic Submission

David Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

Re: **Proposed Definitions required under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), File Number S7-39-10**

Dear Secretary Stawick:

We appreciate the opportunity to provide the Commission with this *Energy Policy Briefing Note*, entitled "The Real Costs of Eliminating Unsecured Credit Lines and Requiring Cash Collateral in OTC Swaps Markets." This note, written by NERA Senior Consultant Kurt Strunk and myself, further describes the methodology and approach used for calculating the cost of capital in our study, "Cost-Benefit Analysis of the CFTC's Proposed Swap Dealer Definition," prepared for the Working Group of Commercial Energy Firms, and on file with the Commission.[1] Thank you for your consideration.

Sincerely yours,

Sharon Brown-Hruska, Ph.D.

[1] Cost-Benefit Analysis of the CFTC's Proposed Swap Dealer Definition, Prepared for the Working Group of Commercial Energy Firms, Dec 20, 2011, at http://comments.cftc.gov/Handlers/PdfHandler.ashx?id=23813

Energy Policy Briefing Note

The Real Costs of Eliminating Unsecured Credit Lines and Requiring Cash Collateral in OTC Swaps Markets[1]

As the Commodity Futures Trading Commission (CFTC) works to finalize its regulation of swaps markets under the Dodd-Frank Wall Street Reform and Consumer Protection Act, a debate is developing around the costs that companies will face if the CFTC's current proposals are adopted. A team of economists within National Economic Research Associates (NERA) spent six months performing a detailed study of the costs for commercial firms that transact primarily in physical energy markets but also use energy swaps for risk management and price discovery. Among the core findings is that the CFTC's proposed regulations will effectively require a large group of market participants to collateralize exposures that are not collateralized in today's marketplace. These market participants would be required to post collateral (also termed margin) for exposures that have until now been deemed acceptable risks up to an unsecured credit threshold.

A key policy question facing the CFTC is whether the benefits of requiring such collateral to be posted by *non-financial* firms justify the costs of doing so. While NERA analyzed both the costs and benefits in its report,[2] recent comments by John Parsons, a professor at the Massachusetts Institute of Technology, raise questions about how to assess the costs correctly.[3] A deeper analysis of this question reveals that, while the principles expounded by Professor Parsons are correct, the proper application of such principles confirms that the methodology used by NERA is reasonable and appropriately captures the costs of posting collateral for the commercial firms studied.

Under the CFTC's proposed rules, non-financial firms will need to post collateral either to a clearinghouse or to a counterparty, including "initial margin" upon execution of a swap transaction and "variation margin" if the position moves against the holder of the swap. The question for economists seeking to assess the costs of the CFTC's proposal is how best to evaluate the cost of the new requirement to post margin to collateralize exposures in the swaps markets. There does not appear to be any dispute over where to

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[1] This *Energy Policy Briefing Note* was prepared by Kurt Strunk and Sharon Brown-Hruska, NERA Economic Consulting. The authors thank James Overdahl and Jeff Makholm for helpful discussions and comments on the draft.

[2] Cost-Benefit Analysis of the CFTC's Proposed Swap Dealer Definition, Prepared for the Working Group of Commercial Energy Firms, Dec 20, 2011, at http://comments.cftc.gov/Handlers/PdfHandler.ashx?id=23813

[3] See John Parsons, Phantom Costs To the Swap Dealer Designation and OTC Reform, Posted January 22, 2012, at http://bettingthebusiness.com/

start. We begin by examining the cost of capital associated with raising funds to post collateral to support swaps transactions.

The guiding principle behind any cost of capital analysis is that a company's financing cost reflects the risks for which the capital is deployed. Riskier investments cost more to finance, while less-risky investments cost less – a simple and intuitive guideline. So how much risk is there in posting cash collateral to support energy swap transactions? Professor Parsons takes issue with NERA's use of the Weighted-Average Cost of Capital as the cost of funds for the collateral and argues instead that the posting of collateral is a relatively low-risk endeavor because the collateral posted is subsequently invested by the counterparty or the clearinghouse in relatively safe assets.

Professor Parsons is right to point out the Weighted-Average Cost of Capital reflects the wide range of business activities in which the corporate parent operates, while the specific cost of capital for posting margin will reflect the risks of this activity alone. This is Finance 101, over which there is no dispute. Yet, by suggesting that posting margin is comparable to investing in low-risk assets, Professor Parsons goes too far. Investing in a treasury bond poses significantly less risk than deploying cash collateral to support volatile energy swaps positions.

Professor Parsons overlooks the risk the value of the collateral could change – a risk that stems from the fact that it is used to secure the ultimate settlement of inherently volatile energy swaps transactions. Price swings in oil and natural gas markets can be substantial. Natural gas swap prices over the past five years have ranged from below $3.00 per MMBTU to over $13 per MMBTU. In 2008, the Brent Crude oil price fell from over $140 per barrel to under $40 per barrel. Electric power swaps can exhibit even greater price volatility, as that commodity cannot be stored. Such price swings trigger exposures and variation margin that, under the CFTC's proposed rules, could exceed the notional value of the swap. This risk may strike some as justifying the need for additional collateral, but we must keep in mind that these exposures are managed against the risks that the firms are exposed to in their underlying business. Absent CFTC regulation, these risks would be subject to collateralization anyway when they exceed reasonable unsecured credit thresholds.

Immediate and large calls for collateral, as would be required under the CFTC's proposed rules, can have significant effects on a firm's cash flows, credit metrics and ability to raise capital. To claim, as Professor Parsons does, that posting collateral used to support swaps transactions in these commodities is a low-risk endeavor focuses on where the capital is temporarily held rather than focusing on the risks to which that capital is exposed. When viewed from a risk perspective, the capital needed to fund a firm's swap transaction activities, including the posting of collateral for such transactions, is exposed to material risks. Because the swaps businesses will tend to be among the riskiest activities within the firm's overall portfolio of businesses, NERA's use of the Weighted-Average Cost of Capital as the cost of funds is conservative.

Furthermore, collateral calls under the CFTC's proposed rules will require that non-financial commercial firms use funds for margin that would otherwise support alternative uses within the commercial enterprise. While commercial energy firms by and large are well capitalized, that capital is tied up in physical assets whose most productive use is likely its current use. From this perspective, NERA's approach appropriately recognizes that the Weighted-Average Cost of Capital represents the opportunity cost of capital for the commercial energy firms that were the subject of our analysis. These firms are not the financial entities the swap dealer designation was intended under the statute to capture. These firms do not have access to funds through the Federal Reserve Bank Discount Window and many assets on their balance sheets are illiquid.

NERA's approach, which calculates the ***net*** cost of collateral, takes into account the possibility that some portion of collateral may be invested in what are deemed to be low-risk assets by the CFTC. This approach is patterned after that used by other government agencies, including that used by the Office of the Comptroller of the Currency. [4] Thus, NERA's approach is economically sound and conservative, since it is by no means guaranteed that returns to collateral will be credited back to the firm posting it and there remains a risk of loss at the clearinghouse or with the clearing firm (as MF Global has so painfully reminded futures customers).

In sum, Professor Parsons incorrectly assumes that commercial energy firms can raise capital in the capital markets at a risk-free or low-risk rate to support their swap transactions. On the contrary, investors in these companies require returns on their capital that appropriately reflect the business and financial risks to which that capital is exposed. Transacting in energy swaps does carry significant business and financial risk and it is not possible to fund such a business at a risk-free or low-risk rate. Further, the Weighted Average Cost of Capital reflects the opportunity costs that the commercial firms would face as a result of having capital tied up as collateral under the CFTC's proposed rules.

As the CFTC continues its analysis of requiring non-financial entities to register as swaps dealers and major swap participants, it is important to consider the costs of the collateral requirements for commercial entities in energy, such as those for whom NERA's study was performed – and commercial entities who transact in agricultural commodity swaps. Many analysts, including those within other government authorities, have predicted collateral requirements to be among the largest potential costs to firms affected by the Dodd-Frank Act, to the consumers whom they serve, and to the economy as a whole.

[4] For example, the Office of the Comptroller of the Currency (OCC) uses a similar approach to ours with respect to initial margin in calculating the net difference in return. See "Unfunded Mandates Reform Act Impact Analysis for Swaps Margin and Capital Rule," April 15, 2011.