

ANALYSIS OF NERA REPORT

Cost-Benefit Analysis of the CFTC's Proposed Swap Dealer Definition Prepared for the Working Group of Commercial Energy Firms

In December of last year, NERA published the above-titled report.¹ NERA is a consulting firm that is a subsidiary of Oliver Wyman, another consulting firm that has been the producer of multiple reports for the financial services industry lobbying group SIFMA, most recently responsible for a report on the costs of the Volcker Rule that was roundly criticized as inaccurate and designed to produce a result that served the political interests of its clients.² Both are owned by Marsh and McLennan, “a global professional services firm providing advice and solutions in the areas of risk, strategy and human capital.”³

NERA describes itself as follows: “NERA’s clients value our ability to apply and communicate state-of-the-art approaches clearly and convincingly, our commitment to deliver unbiased findings, and our reputation for quality and independence.”⁴ Their December Report, like the Oliver Wyman study on the Volcker Rule, is filled with assumptions that are so illogical and weak that the claim of unbiased quality and independence is a matter of significant doubt.

NERA was engaged by a law firm, Hunton & Williams, counsel to the Working Group of Commercial Energy Firms. A review of the many comment letters filed by Hunton & Williams on behalf of the Working Group and the relevant websites provides no list of members of the Working Group. The only indications of membership are lists of attendees at meetings with regulators, which infer membership by a handful of energy firms that sent representatives. If the membership of this organization is hidden from the public, congressional leaders and regulators should discount anything they say.

But if the decision-makers and regulators decide to consider the views of this shadowy organization, they should also consider the quality of the NERA Report, especially in light of what it suggests about the credibility of the Working Group. An organization that puts forth a report that is misleading because of indefensible assumptions and analyses cannot be considered to be a credible and constructive participant in the discussion of implementation of the swap dealer provisions of the Dodd-Frank Act.

The NERA Report has the following stated purpose: “to analyze the incremental costs and benefits [to nonfinancial energy companies] associated with the CFTC’s proposed definition of “Swap Dealer” under the Dodd-Frank [Act].” NERA claims that its “cost-

1 Available at <http://www.sifma.org/issues/item.aspx?id=8589936887> (the “Report”).

2 <http://economix.blogs.nytimes.com/2012/01/19/should-we-trust-paid-experts-on-the-volcker-rule/>

3 <http://www.nera.com/75.htm>

4 <http://www.nera.com/56.htm>

benefit analysis demonstrates that the proposed expansive definition of “Swap Dealer” is contrary to the public interest.”⁵ It is notable that the Report analyzes costs and benefits to a class market participants that it assumes would be found to fall within the definition of “swap dealer” in final rules of the CFTC. The question whether the definition of “swap dealer” currently proposed is in the public’s interest is far beyond the scope of the Report.

The Report reaches a number of specific conclusions:

- . NERA finds that the incremental costs imposed on a typical Nonfinancial Energy Company regulated as a Swap Dealer are approximately:
 - \$153 Million in increased Margin costs
 - \$204 Million in Capital costs
 - \$31 Million to comply with new requirements for Business Conduct, Reporting and Record Keeping
 - **Total of \$388 Million⁶**

The analysis of the Report contained herein is not based on access to specific details of the nonfinancial energy companies studied. However, the Report contains such dramatic conceptual flaws that definitive comments on these three cost components can be made

- Increased Margin Cost: the cost factor applied to increased margin inflates cost by at least a factor of four. In addition, substantial costs that are avoided by margining are ignored. Furthermore, the conceptual errors related to the amount of increased margin dramatically reduce the incremental margin. The cumulative affects of these factors are reasonably expected to reduce the calculation to a small fraction of the cost reported, and conceivably reduce it to zero.
- It is highly likely that the cost of capital should be zero. The Report assumes that capital sufficient to meet the tests of new regulations must be fully costed out, but the capital would undoubtedly be on the balance sheets of the nonfinancial energy companies regardless of the new rules. There would be no incremental capital required and thus no cost.
- Compliance costs are projected based on surveys of the nonfinancial energy companies. Without access to the underlying assumptions, it is impossible to analyze the detail. However, the projections appear to be far too high. For example, the required retention of IMs is estimated (without detailed justification) to cost the typical nonfinancial energy company \$464,000 to set up and \$411,000

⁵ Report at page 1.

⁶ Id.

per year to maintain.⁷

It can be definitively stated that the flaws and inaccuracies, all resulting in inflated costs, are sufficiently serious that the entire Report should be discounted.

ANALYSIS

The first question is what constitutes a typical nonfinancial energy company. The Report first identifies a universe of companies that are deemed to be subject to classification as swap dealers. The list is comprised of each nonfinancial energy company that submitted a comment letter to the CFTC on their proposed rule.⁸ While NERA asserts that this list is probably conservatively small, it makes no assessment of whether the standards set forth in the definition are likely to be met by individual companies. Further, NERA reports no inquiry into whether the portion of the total business of each individual company that might cause them to be so designated is large or small. If it is a small part of their business, the practical result would be that that line of business would be either terminated or some relief from the CFTC would be sought and received.

Nonetheless, the Report relies on surveys of these 26 nonfinancial energy companies to establish the projected facts that underlie the cost/benefit study. The surveys inquire on historic basis as to the relevant facts (and forecasted basis for reporting and recordkeeping costs), such as the amount of margin that might be required to be posted.

In order to estimate the total cost to the industry, NERA simply multiplies individual typical nonfinancial company costs times 26. As stated above, the pool of comment submitters is specious and the assumption that each would simply incur the costs rather than adjust business models is even more so. In the absence of a more rigorous inquiry into potential effects of the regulations and company responses, this fact alone renders the Report in reliable.

Incremental Margin Costs

General Principles

There are a number of specific elements in the calculation set forth in the Report. However, the Report ignores completely a basic, underlying concept.

Measurement of Cost

Calculation of the amount of incremental margin is discussed in detail below (and is shown to be dramatically overstated). In calculating the cost associated with incremental margin, NERA uses an estimate of the weighted average cost of capital for the typical

⁷ Report, Appendix A at page 29.

⁸ Report at page 2 footnote 5.

nonfinancial energy company.⁹ The actual figure used is 9.59% per annum. This percentage is multiplied by the incremental margin to calculate an annual cost.

Use of the weighted average cost of capital is simply wrong (and perhaps designed to achieve a desired result). Margining is a demand on cash flow. The cost of margining is a function of the cost of liquidity financing, not the long-term capital of the entity that must margin

Current 3-month LIBOR is 0.56%. A good estimate of the cost of financing margin would be this amount plus the typical credit spread associated with the nonfinancial energy companies being studied. Without endeavoring to do this calculation since the portfolio of companies used in the Report is unclear, an example is Constellation Energy. The Markit ICE index reports that the CDS spread for Constellation is 1.22%.¹⁰ Thus a better estimate of the cost of liquidity is around 1.8% per annum.

The use of the weighted average cost of capital instead of the short-term liquidity financing cost thus inflates the cost by 4-5 times. This is, of course, before consideration of over-estimation of incremental margin, which is also very large.

Incremental Swaps to be Margined

The Report describes NERA's approach to estimating the scope of the swaps that require margin for purpose of the cost estimate.

For Nonfinancial Energy Companies, a share of swaps that are not cleared today will need to be cleared under the proposed rulemakings, and most bespoke uncleared swaps that are not currently fully collateralized will be required to be fully collateralized. Hence, the initial margin and variation margin posted for those swaps represent an important incremental cost arising from the proposed rulemakings.¹¹

Conceptually, the cost calculation covers uncleared swaps that must be margined because the nonfinancial energy company is a swap dealer and swap that are cleared as a result of the clearing mandate. Cleared swaps should be excluded unless the swaps are subject to the mandate because the nonfinancial energy company is a swap dealer; in other words swaps that would qualify for the end user exemption but for the swap dealer designation. The end user exemption is described by the CFTC as follows:

a swap otherwise subject to mandatory clearing is subject to an elective exception from clearing if one party to the swap is not a financial entity, is using swaps to hedge or mitigate commercial risk, and notifies the Commission, in a manner

⁹ Report, Appendix A at page 24.

¹⁰ Available at <https://www.theice.com/cds/MarkitSingleNames.shtml>.

¹¹ Report, Appendix A at page 22.

set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps.¹²

Thus swaps that qualify for the end user exemption because of the counterparty and cleared swaps (other than swaps that would have qualified but for the swap dealer designation) should be excluded from the analysis. The only swaps that should be included are swaps that would have qualified for the end user exemption, but for the swap dealer designation. Otherwise, swaps are included that would be cleared or margined for reasons having nothing to do with the swap dealer designation.

The Report does not employ detailed methodology for projecting the amount of swaps that involve incremental cost. However, the principles articulated and the actual results dramatically overstate the potential results.

Alternative Cost Avoided. Margining concerns a measurement of financial risk on the part of a counterparty and then the process of collateralization of that risk. NERA explicitly states that the Report is intended to calculate the *incremental* costs that would be experienced by requirements to post.¹³ The incremental cost of posting margin collateral cannot be meaningfully understood unless the cost of not posting is understood to establish an alternative cost avoided. The Report does not identify an alternative cost avoided, so it must be assumed that NERA concludes that there is none.

The counterparty risk that is measured is real. If the counterparty to a nonfinancial energy company forebears from collecting margin collateral, that counterparty carries a credit exposure to that nonfinancial energy company. There is an abundance of academic study that observes that this credit exposure should induce the counterparty to exact a fee, like the credit exposure component of interest on a loan, from the nonfinancial energy company.¹⁴ This is compellingly rational: how else would the counterparty distinguish doing the same derivative transaction with the nonfinancial energy company from another party that may have a better or worse credit standing. The regulators also view un-margined credit exposure in the same way, requiring financial institutions to treat the exposures as credit extensions in terms of reporting, documentation and process (such as explicit caps on the exposure).¹⁵

Indeed, the practices adopted by reasonably prudent market participants conform to this. The price for credit extension is sometimes explicit, but far more often it is embedded in the pricing of the derivative. Most often, assumptions are made about the expected

¹² CFTC, Proposed Rule, End User Exemption, 75 FR 80748.

¹³ Report, Appendix A at page 22.

¹⁴ Professors John Parsons of MIT and Antonio Mello of the University of Wisconsin, <http://bettingthebusiness.com/2011/07/07/historical-fact-and-lobbying-fiction-on-end-users-and-margins/>; <http://bettingthebusiness.com/2011/07/18/924/>.

¹⁵ See the FDIC rules on capital requirements for financial institutions that are swap dealers available at [http://search.fdic.gov/search?q=swap\[+dealers&spell=1&output=xml_no_dtd&ie=UTF-8&client=wwwGOV&proxystylesheet=wwwGOV&site=default&access=p](http://search.fdic.gov/search?q=swap[+dealers&spell=1&output=xml_no_dtd&ie=UTF-8&client=wwwGOV&proxystylesheet=wwwGOV&site=default&access=p).

amount of credit exposure and a charge based on appropriate credit spreads is embedded. The Report has to consider this cost of the alternative to posting and net it out to produce a valid estimate.

Yet this is not a full alternative cost avoided calculation. Counterparty credit agreements sensibly require posting under specified conditions, generally adverse credit events. Therefore, a nonfinancial energy company that does not post faces the prospect of an immediate required posting at a time when it is under the most stress financially. (It should be noted that Constellation, a member of the Working Group experienced this in 2008, requiring an emergency, and costly, bailout by Warren Buffet's organization and a subsequent sale of majority interests in its nuclear facilities to Electricite de France.) The only reasonable way to conduct business in this way is to maintain available liquidity lines. The cost of such lines (or alternatively the cost of the risk of not having lines) must be added to the cost avoided calculation.

Initial Margin

This consideration of initial margin is intended to measure (a) initial margin on swaps that must be margined because a given nonfinancial energy company is designated as a swap dealer and (b) swaps "that will be subject to mandatory clearing."¹⁶ As discussed, the second purpose is too broad: it should include only swaps between the non-financial energy company and swap dealers in which the non-financial energy company would otherwise qualify as an end user.

From the perspective of assumptions and analytical approach, the Report is deeply flawed:

For all affected swaps, the survey indicates that initial margin would have been \$51 million per firm, on average, given the swap positions that were held by the surveyed firms during 2010. The CFTC's proposed rule does permit a portfolio-based reduction in initial margin. *Therefore, if the Nonfinancial Energy Companies were able to demonstrate sufficient portfolio offsets, this value would be reduced.* [Emphasis added.]¹⁷

The very nature of being a dealer is to buy and sell. Netting of long and short positions is essential to the activity. If swaps are cleared, this netting is absolute. If swaps are not cleared, netting is bi-lateral. But even where longs and shorts cannot be bilaterally netted, the cost of margining must be offset by earnings on the margin collateral of other parties held. To have ignored netting in the calculation is to ignore a basic element of the activity being analyzed.

¹⁶ Report, Appendix A at page 22.

¹⁷ Report, Appendix A at page 23.

Variation Margin

The calculations of the incremental costs of variation margin in the Report are subject to the same flaws as the initial margin calculations: they overstated the cleared component; and netting is ignored.¹⁸

However the netting flaw is much worse. While initial margin may not be fully nettable for un-cleared swaps, variation margin should be. Initial margin secures potential price moves, while variation margin cashes out prior price moves. In the money and out of the money positions should be netted regardless of counterparties.

Collateral Segregation Costs

The Report states that the CFYC's proposed rules provide that "Dealer-to-dealer initial margin must be segregated. Such collateral must be held by a third party and cannot be used for other purposes."¹⁹ The problem is that that is simply not what the proposed rules say.

(a) At the beginning of each swap transaction that is not submitted for clearing, a swap dealer or major swap participant shall notify each counterparty to such transaction that *the counterparty has the right to require that any Initial Margin the counterparty provides in connection with such transaction be segregated* in accordance with §§ 23.602 and 23.603 of this part.

(b) The right referred to in paragraph (a) of this section *does not extend to Variation Margin*. [Emphasis added.]²⁰

Thus it is an election and only applies to variation margin. The precise calculations used by NERA to evaluate this cost are not provided. However, any cost must assume that counterparties choose segregation, which is something that they could bargain for in the current market. The actual cost of this provision should be minimal if anything.

Incremental Capital Cost

¹⁸ Id.

¹⁹ Id.

²⁰ CFTC Proposed Rules, Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 75 FR 75438.

The Report provides some detail regarding the calculation of the minimum amounts of tangible net equity required to be maintained by non-financial swap dealers. The specifics of these calculations are not considered herein. That is because the basic approach of the cost analysis is so flawed that such the details of the calculations are not relevant.

The Report properly recites the requirements of the regulations

Dodd-Frank also calls for capital requirements for Swap Dealers and Major Swap Participants. The proposed rulemaking “Capital Requirements of Swap Dealers and Major Swap Participants” delineates these new rules. Each Swap Dealer and Major Swap Participant *must have tangible net equity sufficient to cover a market risk and credit risk charge, plus an additional \$20 million*. Both charges are explained below.²¹

Thus the requirement of the regulation is that a swap dealer must have tangible net equity at least equal to the required number. It does not require that this tangible net equity be set aside or sequestered in any way, just that the balance sheet of the nonfinancial energy company indicate that it meets the standard.

The calculation of the incremental cost of capital completely ignores this:

Our survey indicates that the *average total regulatory capital requirement would be \$222 million*, which reflects the sum of the credit risk capital requirement, the market risk capital requirement and the additional \$20 million required under the proposed rules. *To this, NERA applies the net carrying cost rate for capital of 16.13 percent resulting in an average annual cost of \$36 million per firm*, assuming capital is an incremental cost for a particular Swap Dealer. [Emphasis added.]²²

To the extent that the typical nonfinancial energy company carries \$222 million of tangible net equity, there should be no cost since that amount would not be incremental. Generally speaking, tangible net equity is the same thing as net equity without consideration of intangibles such as goodwill, copyrights and patents.²³ It would include, for instance, power plants, transmission facilities, pipelines and oil, gas and coal reserves. Of all classes of companies, energy companies should be expected have among the largest

²¹ Report, Appendix A at page 24.

²² Report, Appendix A at page 26.

²³ See <http://www.investopedia.com/terms/t/tangiblenetworth.asp#axzz1kLiJlQ86>.

tangible net equity. The cost calculation by NERA is not only incorrect; it almost undoubtedly should yield a result of zero.