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Robert E. Feldman, Executive Secretary
Attention: Comments/RIN 3064-AE80
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Re: Comments on **Standardized Approach for Calculating the Exposure Amount of Derivative Contracts**, as proposed in: Docket ID OCC-2018-0030, RIN 1557-AE44; Docket R-1629, RIN 7100-AF22; and RIN 3064-AE80

Dear Ms. Misback, Mr. Feldman and the Comptroller of the Currency:

Thank you for the opportunity to submit comments on the above-captioned notice of proposed rulemaking ("NOPR"), regarding proposed revisions to the standardized approach for calculating the exposure amount ("SA-CCR") published at 83 Fed. Reg. 64,660 (December 17, 2018). California Resources Corporation ("CRC") is an independent oil and natural gas exploration and production company operating properties exclusively within the state of California. CRC is the largest oil and natural gas producer in California on a gross-operated basis.

Integral to our business is the activity of hedging the business risk that comes naturally with the cyclical nature of commodity prices. CRC's hedging activity is done using derivative instruments enumerated in the Dodd Frank Act ("DFA") under the Swap definition. As a Non-Financial End-User (End-User) defined by the Dodd Frank Act, CRC does not make a market in swaps. We only engage in hedging derivatives with swap dealers that regularly use derivatives in the ordinary course of their business. As an End-User, we utilize hedges to help protect our cash flows, margins and capital program from the volatility of commodity prices and to improve our ability to comply with financial covenants under our credit facilities.

Accordingly, we respectfully submit our comments as an End-User to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (the "Agencies"). We have concerns that the NOPR would, if adopted, have a devastating impact on our ability to hedge, and therefore our ability to manage commodity price risk inherent in our business.

The Agencies ask specific questions in the proposed rule upon which the public is invited to comment. Two of these questions involve the general aspects of the proposal, and the proposed definitions, along with suggested alternative definitions. These are the main points discussed in this comment letter.

I. General Aspects of the Proposed Rule

As stated on page 64661 of the proposed rule, the new approach for counterparty risk would "provide important improvements to risk sensitivity and calibration relative to CEM, but also would provide a less complex and non-model-dependent approach than IMM." CRC understands the importance of risk sensitivity regarding credit exposure and agrees that a well-functioning marketplace includes precautions for such risks. In this instance, however, CRC respectfully disagrees with the end results of the NOPR if the proposed methodology were applied to commodity derivatives as set forth in the proposed rule.

As an End-User, hedging is a key tool for managing the price risk inherent in our business. The main hedging method is to employ over the counter ("OTC") derivatives in lieu of listed futures on exchanges since our End-User exemption under the DFA allows us to avoid the burden of clearing transactions and the time-consuming and expensive processes managing the posting and recall of collateral on a daily basis.

Utilizing the OTC market allows End-Users to customize derivative instruments to adequately hedge price risk in such a way that is not available in the cleared futures market. OTC contracts allow our counterparties to take advantage of provisions within our credit agreements to extend first lien security to their hedges and avoid margin requirements. The ability to avoid margin requirements is essential for us to manage our liquidity within the requirements of our credit agreements. Our counterparties recognize the right way credit risk in our hedging strategies where a <u>rise in commodity prices improves our inherent credit worthiness which offsets any increase in exposure to the counterparty</u>. Likewise, a drop in commodity prices would result in a decline of our credit quality, however this risk to the counterparty would be offset by a corresponding reduction in counterparty exposure to us for purposes of calculating their reserve or margining requirements under the proposed rule.

The proposed exposure method under SA-CCR disproportionately impacts commodity-based derivatives relative to Foreign Exchange or Interest Rate derivatives. As an example, for a

1-year crude oil swap, the proposed exposure method would result in an exposure that is four times higher than the current method used. This is substantially higher than the expected increase in exposures of 90% as stated in the NOPR. Longer term hedges will have an even higher exposure requirement and will be disproportionately impacted by this proposed rule.

The proposed rule as designed also fails to recognize letters of credit or security interests in assets as valid credit mitigation instruments to offset exposures and only considers cash collateral in the calculation. Security interests and letters of credit are industry accepted credit mitigation tools and apply more straightforward processes which can be maintained without as much of a burden on our liquidity relative to a daily cash margining program. We believe the proposed rule should take into consideration these tools as valid offsets to credit exposures.

Further, End-Users tend to not have off-setting derivatives positions and cannot take advantage of the netting provisions contained in the proposed rule. For us, our natural offsets are our tangible production and related assets to which the proposed rule does not grant any standing.

Implementation of the rule as proposed could significantly impact an End-User's ability to engage in an effective and economical hedging program by decreasing availability of counterparty credit, cause the exit of institutions from this market, increase costs, and reduce liquidity for End-Users within the Commodity Derivatives market. In addition, our counterparties may demand that we update our contracts to include margining provisions or other contract concessions. A cash margining program would require the daily calculation of exposures, off-sets and cash balances; and significant daily reconciliation of margin calls and requests for return of margin against contractual requirements, internal policies and controls. A regulatory change to impose cash margining would also unnecessarily tie up liquidity, significantly impacting our ability to meet our financial covenants. Reducing our access to the hedging markets or imposing excessive cost and impact on our liquidity caused by margin requirements could have the perverse effect of forcing us to be underhedged which can result in increased overall risk to our business and ultimately higher credit risk to our counterparties.

For the reasons stated above, we respectfully request that End-User transactions be exempt from this rule, maintaining the carve-out enshrined in the DFA and allowing End-Users to do what they do best—grow their businesses and provide good paying jobs and essential products to their fellow Americans.

II. Alternative Definitions for the Agencies to Consider, Particularly to Achieve Greater Consistency Across Other Agencies' Regulations.

On page 64663 in the NOPR, Section C states "In general, derivative contracts represent agreements 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." The Federal Reserve Board's general definition of derivative contracts in 12 CFR 217.2 is as follows:

> "Derivative contract means a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. Derivative contracts include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, credit derivative contracts, and any other instrument that poses similar counterparty credit risks. Derivative contracts also include unsettled securities, commodities, and foreign exchange transactions with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular instrument or five business days."

In contrast, Section 1a(47)(A) of the Commodity Exchange Act ("CEA") – the more specific statute governing the Commodity Futures Trading Commission ("CFTC") -- expressly <u>excludes</u> forward contracts from the definition of derivative or "swap", regardless of time. A forward contract is generally defined as a contract that is intended to be physically settled. This is in harmonization with Congressional intention in the Dodd Frank Act as reflected in 156 Cong. Rec. H5248–49 (June 30, 2010).

In the ordinary course of business, we routinely engage in physical delivery contracts with settlements greater than five days after delivery with entities covered by this rule. The CFTC has specifically excluded forward contracts that are physically settled from the definition of derivative or swap and the inclusion of them in the proposed rule will have adverse consequences on our business. This includes reduction in market liquidity, loss of valuable counterparties and customers, reduction in available unsecured credit and lower prices received for our production.

We believe it is of particular importance to have inter-agency alignment in the definition of derivatives as section 4s(e)(3)(D)(ii) of the CEA provides that "Prudential Regulators, the Commodity Futures Trading Commission ("CFTC"), and the Securities and Exchange Commission ("SEC") are to establish and maintain, to the maximum extent possible, comparable minimum capital and minimum initial and variation margin requirements, including the use of noncash collateral for swap dealers and major swap participants." The NOPR notes on page 64662 that the "industry has raised concerns that CEM does not appropriately recognize collateral, including the risk-reducing nature of variation and margin," but the proposed rule does not address non-cash collateral. As stated in the section above, the CEA requires the Prudential Regulators, CFTC, and the SEC to <u>work through margin and capital requirements together</u>.

III. Impact of the Proposed Rule

The anticipated result of the proposed rule is expressed on page 64685. It states that the exposure amounts of unmargined derivative contracts would increase by approximately 90 percent when utilizing SA-CCR as compared to CEM. This outcome frustrates the intention of Congress in the CEA by forcing credit-issuing banks to pass on those costs to the End-User customer. This outcome would have the effect of causing a non-financial End-User like CRC to post margin due to the higher exposure percentage in the proposed rule. This misalignment with End-Users in the proposed rule could be avoided if there were an End-User counterparty carve out.

Under the DFA, non-financial End-Users are exempt from the clearing and margin requirements. There is no such carve out in the proposed rule. Additionally, the "End-User exception" to mandatory clearing of swaps under Section 2(h)(7)(A) of the CEA and a "hedging affiliate" exception to clearing under Section 2(h)(7)(D) of the CEA are only available for swaps that are entered into to hedge or mitigate an entity's exposure to commercial risk. We believe these exceptions under Dodd-Frank were provided to End-Users, because these activities are done outside the normal course of their business only with the intent to hedge, and thereby reduce their inherent risk for their creditors. Therefore, we believe the intent of Dodd-Frank was to promote the use of derivatives by End-Users to reduce risk, which we are concerned that the NOPR would eliminate and makes it more difficult for us to effectively hedge.

CRC is concerned that without the forward contract exclusion in the definition of derivative, and with uncertainty regarding inter-agency agreement on definitions, the various derivative standards would cause higher volatility, a chilling effect on healthy market activity, and a cessation of strong credit participation. This very outcome that the NOPR sought to avoid.

IV. Conclusion and Alternative

CRC respectfully requests that End-User transactions be exempt from the proposed rule, thereby maintaining the carve-out enshrined in Dodd Frank, aligning with regulations under the CEA and allowing End-Users to do what they do best—grow their businesses and provide good paying jobs and essential products to their fellow Americans.

If our request cannot be granted, in the alternative to the above, we request a reduction in supervisory factors and volatility factors for Commodity derivatives for End-Users; allowance for recognition of right way credit risk by our counterparties and the recognition of letters of credit and security interests in tangible assets as valid offsets to credit exposures.

Thank you for the opportunity to provide our comments to the Proposed Rule. If we can be of any assistance in this process, please reach out to us at RPineci@crc.com or 818-661-6021.

Respectfully submitted,

[redacted]

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