FEDERAL RESERVE SYSTEM

The Royal Bank of Scotland Group plc
Edinburgh, Scotland

Order Approving Notice to Engage in
Activities Complementary to a Financial Activity

The Royal Bank of Scotland Group plc ("RBS"), a financial holding company ("FHC") for purposes of the Bank Holding Company Act ("BHC Act"), has requested the Board's approval under section 4 of the BHC Act[1] and the Board's Regulation Y[2] to engage in physical commodity trading, which involves entering into contracts that may require making or taking physical delivery of or storing commodities ("Physical Commodity Trading"), and providing energy management services ("Energy Management Services") for owners of power generation facilities under energy management agreements. The Board has previously found Physical Commodity Trading and Energy Management Services to be activities that are complementary to the financial activity of engaging as principal in commodity derivatives transactions and, in the case of Energy Management Services, also complementary to providing financial and investment advisory services for derivatives transactions.

In addition, RBS has requested approval to engage in physically settled energy tolling by entering into tolling agreements with power plant owners ("Energy Tolling") as an activity that is complementary to the financial activity of engaging as principal in commodity derivatives transactions. The Board has not previously considered whether Energy Tolling is complementary to a financial activity. RBS proposes to engage in such complementary activities through a joint venture company

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[1] 12 U.S.C. § 1843.

[2] 12 CFR Part 225.

("JV") formed with Sempra Energy ("Sempra"), San Diego, California, an energy services company.[3]

Background

The Board's Regulation Y currently permits bank holding companies ("BHCs") to (i) enter into derivative contracts that are based on nonfinancial commodities ("Commodity Derivatives Activities"), and (ii) provide information, statistical forecasting, and advice with respect to transactions in foreign exchange, swaps, and similar transactions; commodities; and any forward contract, option, future, option on a future, and similar instruments ("Derivatives Advisory Services"), as activities that are closely related to banking.[4]

The BHC Act, as amended by the Gramm-Leach-Bliley Act, permits BHCs that qualify as FHCs to engage in an expanded set of activities that are defined by statute to be financial in nature, as well as any additional activity that the Board determines, in consultation with the Secretary of the Treasury, to be financial in nature or incidental to a financial activity.[5]

The BHC Act also permits FHCs to engage in any activity that the Board determines is complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.[6] This authority is intended to allow the Board to permit FHCs to engage on a limited basis in activities that, although not necessarily financial in nature, are so meaningfully connected to financial activities that they complement those activities. In this way, FHCs would not be disadvantaged by market developments if commercial activities evolve into financial

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[3] RBS would own 51 percent of JV, which would be headquartered in the United Kingdom.

[4] 12 CFR 225.28(b)(8)(ii). Under Regulation Y, a BHC is permitted to engage in Commodity Derivatives Activities but is generally not allowed to take or make delivery of the nonfinancial commodities underlying commodity derivatives or purchase or sell nonfinancial commodities in the spot market.

[5] 12 U.S.C. § 1843(k)(1)(A).

[6] 12 U.S.C. § 1843(k)(1)(B).

activities or competitors find innovative ways to combine financial and nonfinancial activities. The BHC Act provides the Board with exclusive authority to determine that an activity is complementary to a financial activity.

The BHC Act further provides that any FHC seeking to engage in a complementary activity must obtain the Board's prior approval. When reviewing such a proposal, the BHC Act requires the Board to consider whether performance of the activity by the FHC can reasonably be expected to produce public benefits that outweigh possible adverse effects, such as "undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices."[7] Moreover, the Board previously has stated that complementary activities should be limited in size and scope relative to an FHC's financial activities.[8] The Board has approved Physical Commodity Trading[9] and Energy Management Services[10] as activities that are complementary to financial activities. As noted, the Board has not previously considered a request by an FHC to engage in Energy Tolling.

RBS currently engages in Commodity Derivatives Activities and Derivatives Advisory Services (both are financial activities) in the United States. RBS has requested approval to engage in Physical Commodity Trading and Energy Tolling as activities that are complementary to its Commodity Derivatives Activities

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7 12 U.S.C. § 1843(j)(2)(A).

8 See 68 Federal Register 68493, 68497 (Dec. 9, 2003); see also 145 Cong. Rec. H11529 (daily ed. Nov. 4, 1999) (Statement of Chairman Leach) ("It is expected that complementary activities would not be significant relative to the overall financial activities of the organization.").

9 Board letters regarding Bank of America Corporation (April 24, 2007), Credit Suisse Group (March 27, 2007), Fortis S.A./N.V. (September 29, 2006), and Wachovia Corporation (April 13, 2006); and Board orders regarding Société Générale, 92 Federal Reserve Bulletin C113 (2006); Deutsche Bank AG, 91 Federal Reserve Bulletin C54 (2005); JPMorgan Chase & Co., 91 Federal Reserve Bulletin C57 (2005); Barclays Bank PLC, 90 Federal Reserve Bulletin 511 (2004); UBS AG, 90 Federal Reserve Bulletin 215 (2004); and Citigroup Inc., 89 Federal Reserve Bulletin 508 (2003).

10 Fortis S.A./N.V., 94 Federal Reserve Bulletin C20 (2008).

and to provide Energy Management Services as an activity that is complementary to both its Commodity Derivatives Activities and Derivatives Advisory Services.

RBS's Proposal

RBS operates in the United States through Citizens Financial Group, Inc., Providence, Rhode Island, a multibank holding company, as well as through branches in New York, New York, and Greenwich, Connecticut, and representative offices in Houston, Texas, and Los Angeles, California.[11] RBS also operates nonbanking companies in the United States, including a broker-dealer subsidiary, RBS Greenwich Capital, Greenwich, Connecticut.

RBS proposes to expand its commodity-related activities by forming JV with Sempra. A subsidiary of Sempra, Sempra Energy Trading Corp. ("SET"), that engages in commodity derivatives transactions and physical commodity trading would be transferred to JV.[12] SET acts as principal in commodity transactions in and outside the United States and takes and makes physical delivery of commodities in connection with those transactions. SET also acts as an energy manager and enters into tolling agreements with power plant owners. RBS proposes to engage in Physical Commodity Trading, Energy Tolling, and Energy Management Services under the complementary activity authority of section 4 of the BHC Act so that the SET Companies transferred to JV may continue to conduct these activities.[13]

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[11] RBS also holds a 38.3 percent interest in RFS, a financial holding company formed by a consortium of banking organizations, including Fortis N.V., Utrecht, Netherlands, and certain of its affiliates and Banco Santander Central Hispano, S.A., Madrid, Spain, that recently acquired ABN AMRO Holding N.V., Amsterdam, Netherlands ("ABN AMRO"). On approval of the consortium's restructuring plan by ABN AMRO's home country supervisor, RBS will acquire ABN AMRO's direct U.S. branches and representative offices.

[12] JV proposes to purchase SET and its related energy trading subsidiaries and affiliates ("SET Companies"), which would become JV's subsidiaries.

[13] As set forth in the appendix, RBS has committed that within two years of consummation of the transaction it will conform, including by divestiture if necessary, any activities that are impermissible for an FHC under the BHC Act or that are inconsistent with the activities permitted by this order.

Physical Commodity Trading

RBS currently engages in Commodity Derivatives Activities in the United States and proposes to expand those activities and to engage in Physical Commodity Trading through JV. JV's activities would include taking or making delivery of permissible commodities pursuant to physically settled commodity derivatives; taking inventory positions in natural gas, oil, emissions allowances, and other permissible commodities; and engaging in other spot market trading activities. RBS has also indicated that JV might engage in commodity-related financing transactions, including volumetric production payment transactions ("VPPs").[14]

As noted, the Board previously has determined that Physical Commodity Trading is a permissible activity because it complements the financial activity of engaging in Commodity Derivatives Activities. Most of the transactions in which RBS proposes to engage as part of Physical Commodity Trading do not differ from transactions that the Board has approved. RBS proposes to engage, however, in a wider set of transactions under the Physical Commodity Trading authority and requests confirmation that these activities are within the scope of that authority.

Specifically, RBS proposes to enter into long-term power supply contracts with large commercial and industrial end-users; to engage in physical trading in

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[14] RBS may engage in VPPs on oil and gas as permissible credit transactions if it agrees to sell the oil or gas it receives under the VPP to third parties before delivery. VPPs are a means of financing oil and gas exploration and production. Under a VPP, the lender or VPP holder provides an up-front payment in exchange for a royalty interest that entitles the VPP holder to receive hydrocarbons on a regular basis during the life of the VPP transaction in quantities that will allow the VPP holder to recover its up-front payment and a specified return. The Board's General Counsel has determined that VPPs generally are considered extensions of credit permissible for a BHC under section 225.28(b)(1) of Regulation Y, if the BHC agrees to sell the commodities before delivery. See letter from Scott G. Alvarez to Elizabeth T. Davy, May 15, 2006, regarding UBS AG ("UBS Letter"). RBS has confirmed that all VPP transactions will conform in all material respects to the description of permissible VPP transactions set forth in the UBS Letter, including a commitment that any commodities that RBS receives under the VPP and does not immediately sell to a third party will count against the 5 percent cap on RBS's total physical commodity holdings, which is discussed below.

commodities for which derivatives contracts have not been approved by the Commodity Futures Trading Commission ("CFTC") for trading on a U.S. exchange or specifically approved by the Board; and to enter into contracts with third parties to process, refine, or otherwise alter commodities.

A. Long-Term Electricity Supply Contracts

As part of its energy trading business, RBS proposes to enter into long-term electricity supply contracts with large commercial and industrial customers. The current Physical Commodity Trading authority permits an FHC to take a position in a commodity and does not limit the duration of, or counterparties to, an FHC's contracts. Most commodities in which an FHC may trade under the Physical Commodity Trading authority, however, tend by their nature to be limited to the wholesale market. Electricity, on the other hand, has a greater potential to be sold not only to end-users generally but also to small retail customers who are unlikely to be participants in the market for energy-related derivatives products.

To ensure that RBS's activities remain consistent with the general complementary nature of the activities permitted under the Physical Commodity Trading authority, RBS has committed to enter into long-term supply contracts only with large industrial and commercial customers. Market risk relating to these long-term contracts would be handled by the same methodologies used for other electricity trades.

RBS has represented that in all states where the electricity market has been deregulated, state regulations distinguish among types of end-users. To distinguish types of customers, states generally rely on the customer's typical electricity consumption level.[15] To ensure that RBS contracts only with customers who are sufficiently large and sophisticated, RBS has committed that it will enter into long-term electricity supply contracts only with commercial and industrial customers that consume electricity at a rate of at least (i) 800 megawatt-hours/year ("MWHrs/year") or (ii) the minimum

[15] For example, the minimum consumption level to be considered a large commercial or industrial customer under state regulations is 175 MWHrs/year in California, 220 MWHrs/year in Pennsylvania, and 876 MWHrs/year in Washington, D.C.

consumption level for large commercial and industrial customers under applicable state law, whichever is greater. This restriction should be sufficient to ensure that RBS transacts with financially sophisticated purchasers (and not with retail purchasers) and thus remains essentially a wholesale intermediary.

B. Physical Trading in Certain Commodities not Approved by the CFTC for Trading on a Futures Exchange

The Board has conditioned its approval of notices to engage in Physical Commodity Trading on a commitment by the FHC to trade only in commodities for which derivative contracts have been approved for trading on a futures exchange by the CFTC (unless specifically excluded by the Board) or that have been specifically approved by the Board ("Approved Commodities Commitment"). This commitment provided a means to ensure that the Physical Commodity Trading remained complementary to the financial activity of Commodity Derivatives Activities because it helped demonstrate that there was a derivatives market for the underlying commodity. This commitment also was intended to prevent FHCs from dealing in finished goods and other items, such as real estate or industrial products that lack the fungibility and liquidity of exchange-traded commodities. The Board believes that, subject to certain requirements, an FHC may take delivery of certain commodities that have not been approved by the CFTC category but are similarly fungible and liquid without being exposed to significant additional risk.

1. Commodities that are Approved for Trading on Non-U.S. Exchanges. The test that a commodity derivative be approved by the CFTC is a useful, but not a comprehensive, test of whether a derivative or the underlying commodity is liquid and fungible. For some liquid and fungible commodities, no market-maker has sought CFTC approval because of the presence of an established foreign trading market, which may deter a U.S. exchange from listing a similar product. The absence of CFTC approval in those cases generally would not indicate that taking and making physical delivery of the commodity would entail substantially greater risks than taking and making delivery of a CFTC-approved commodity. As a general matter, the fact that a derivatives contract

based on the commodity trades on a non-U.S. exchange that is subject to a regulatory structure comparable to the one administered by the CFTC should be sufficient to demonstrate that there is a market in financially settled contracts on the commodities, the commodity is fungible, and a reasonably liquid market for the commodity exists.

RBS specifically has requested approval to take and make physical delivery of nickel, a metal that is widely and actively traded on the London Metal Exchange ("LME"), one of the largest nonferrous metal markets in the world. The LME offers futures and options contracts for aluminum, copper, nickel, tin, zinc, and certain aluminum alloy contracts. The LME is a highly liquid,[16] global market that derives more than 95 percent of its business from outside the United Kingdom. The CFTC has determined that the LME is subject to a regulatory structure comparable to that administered by the CFTC under the Commodity Exchange Act. As a result, members of the LME may conduct brokerage activities for U.S. customers without having to register with the CFTC as a futures commission merchant or otherwise comply with certain of the CFTC's consumer protection rules.[17] Given the nature of the LME trading market and the CFTC's determination that LME members are subject to comparable regulatory oversight, the Board has determined that FHCs that receive approval to engage in Physical Commodity Trading may take and make delivery of nickel. The Board has determined that other FHCs that have already received approval to engage in Physical Commodity Trading may also make and take delivery of nickel, consistent with the

[16] In 2006, the LME reported that it recorded volumes of 87 million lots, equivalent to $8.1 trillion annually and $35 billion to $45 billion on an average business day.

[17] The CFTC's Rule 30.10 permits a person affected by the requirements contained in Part 30 of the CFTC's rules, which relate to registration as a futures commission merchant, to petition the CFTC for an exemption from the requirements based on the person's substituted compliance with a foreign regulatory structure found comparable to that administered by the CFTC under the Commodities Exchange Act. The inclusion of the LME in the CFTC's so-called "30.10 program" is reflected in an order issued by the CFTC to the U.K.'s Financial Services Authority that consolidates the relief set forth in prior orders issued pursuant to Rule 30.10 regarding sales of futures and options to customers in the United States by certain firms in the United Kingdom. 68 Federal Register 58583 (2003).

Approved Commodities Commitment, as a commodity that has been specifically approved by the Board.

2. Commodities that are Not Approved for Trading in the United States or on Certain Non-U.S. Exchanges. Many commodities for which derivatives contracts have not been approved for trading by the CFTC or that are not traded on a non-U.S. exchange may also be commodities that have viable markets with financially settled contracts on the commodities and that satisfy fungibility and liquidity concerns. In many cases, the existence of an established over-the-counter market obviates the need to seek CFTC approval for listing on a futures exchange. In addition, the particular commodity may be so similar to a CFTC-approved commodity, such as a product that is derived from a CFTC-approved commodity, that the separate listing is superfluous because market participants can use derivatives contracts on the CFTC-approved commodity to hedge their positions in the non-CFTC-approved derivative product.

The Board believes that taking and making physical delivery of non-CFTC-approved commodities may be consistent with the Physical Commodity Trading authority if an FHC can demonstrate that (i) there is a market in financially settled contracts on those commodities in addition to the physically settled contracts, (ii) the particular commodity is fungible, and (iii) the market for the commodity is sufficiently liquid. In addition, the FHC must demonstrate that it has trading limits in place that address both concentration risk and overall exposure to the commodity to ensure that the FHC could physically trade in these commodities without incurring significant additional risk.

As noted above, RBS has requested authority to trade in certain natural gas liquids, oil products, and petrochemicals. Specifically, the proposed natural gas liquids are butane, ethane, and natural gasoline; the proposed oil products are asphalt, condensate, boiler cutter, residual fuel oil no. 6, kerosene, straight run, marine diesel, and naphtha; and the proposed petrochemicals are ethylene, paraxylene, styrene, propylene, and toluene ("Proposed Commodities"). Contracts on these commodities are not approved for trading on a U.S. futures exchange by the CFTC or on a major non-U.S. exchange. Nonetheless, a number of considerations support a Board determination that trading in the Proposed Commodities should be permitted as part of the Physical Commodity Trading authority.

Market in financially settled contracts. Many commodities trade on established alternative trading platforms ("ATP") that are used by a wide variety of market participants, rather than on a futures exchange. If derivatives contracts on a commodity trade on a recognized ATP, that activity could serve as sufficient evidence that a market in financially settled contracts on the particular commodity exists. Financially and physically settled contracts for all the Proposed Commodities trade on recognized ATPs. Specifically, the natural gas liquids are traded on the Intercontinental Exchange ("ICE") and on the New York Mercantile Exchange ("NYMEX") electronic trading platforms; the distillate and residual oil products trade on ICE and NYMEX; and the petrochemicals are traded on the Chemconnect electronic trading platform. These ATPs are major platforms that are widely used by a variety of producers, consumers, and traders of the Proposed Commodities.

Fungibility. To ensure that a commodity is fungible, an FHC must demonstrate that no specification of exact product or lot would be included for contracts on the commodity. In other words, the physical asset that may be delivered to satisfy a contract would be, by nature or usage of trade, the equivalent of any other unit of the asset. The Proposed Commodities, which trade on ICE, NYMEX, and Chemconnect, are fungible because market participants contract for specific quantities of the commodity but cannot specify the particular product they will receive.

Liquidity. To ensure that the market for a particular commodity is sufficiently liquid, an FHC must demonstrate that an active trading market in the commodity exists that would allow the institution to limit its position in the commodity relative to the volume that trades in the market generally. The Board believes the following factors indicate that a reasonably liquid market exists: (i) reliable trading volume in the commodity or production statistics exist that demonstrate the size of the market in the commodity; (ii) daily or intraday price data on the commodity are published; and (iii) a number of market makers in the commodity stand ready to buy or sell the commodity each day at published bid and offer quotations. Each of the Proposed Commodities is derived from CFTC-approved commodities (natural gas and oil) and is used, similar to CFTC-approved commodities, as fuel or as inputs for finished products. The Proposed Commodities are traded widely through brokers on the ATPs discussed above and physically traded at various hubs in the United States and abroad.[18] There are numerous participants in the trading markets for the Proposed Commodities, and published production statistics exist for all the Proposed Commodities. Reliable independent price reporting for the Proposed Commodities is widely available from a number of sources, such as Platts, a division of The McGraw-Hill Companies that provides information on the energy and metals markets, and the Argus Media Group, an energy news and price-reporting agency. Prices for both buy and sell offers are posted daily by the ATPs on which the Proposed Commodities trade.

Trading limits. An FHC that proposes to trade in a new commodity must demonstrate that it has established appropriate limits on its trading in the commodity and has a risk-management program in place to monitor compliance with those limits, which must include both concentration limits and overall exposure limits. RBS has represented that as part of its risk-management program relating to the Proposed Commodities, it will impose appropriate concentration and overall exposure limits for each Proposed Commodity.

In light of the characteristics of the Proposed Commodities and based on all the facts of record, the Board has determined that taking physical delivery of the Proposed Commodities is consistent with the complementary nature of Physical

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[18] Specifically, natural gas liquids are physically traded in the United States at hubs in Texas and Kansas; the distillate and residual oil products are physically traded at various points in the United States as well as the Caribbean, Africa, Europe, and Singapore; and the petrochemicals are physically traded at various points in the United States, South Korea, and Thailand.

Commodity Trading and does not present undue safety and soundness concerns for RBS.[19]

3. Altering Commodities. As noted, the Board has previously approved Physical Commodity Trading, on a limited basis, subject to a number of commitments, including that the FHC not process, refine, or otherwise alter a commodity. RBS proposes to engage third parties to refine, blend, or otherwise alter commodities for which it is permitted to take and make physical delivery.

A number of considerations support the Board's determination that engaging a third party to alter a commodity is consistent with the existing Physical Commodity Trading authority. Permitting RBS to engage a third party to alter a commodity would not significantly increase the risks to the institution from Physical Commodity Trading. Under this authority, an FHC may already engage a third party to store commodities, which exposes an FHC to substantially the same types of risks as engaging a third party to alter a commodity. Moreover, an FHC could sell a commodity to a refinery and buy back the refined commodity if both the commodity sold to and bought from the refinery were permissible commodities. Permitting an FHC to engage third parties to alter commodities also would enhance an FHC's ability to meet its customers' needs.

To ensure that the activity remains consistent with the scope of Physical Commodity Trading, RBS has made the following commitments: (i) RBS will not alter commodities itself; (ii) both the commodity input and the resulting altered commodity will be permissible commodities under the Board's decisions; and (iii) RBS will not have exclusive rights to use the alteration facility. Requiring that both the commodity input and the altered commodity be permissible commodities under the Board's decisions helps ensure that RBS would not assume the risk of taking and making physical delivery of

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[19] Because trading the Proposed Commodities might require that an FHC adapt a particular risk-management program beyond what would be required to trade in the commodities that are currently permissible, this order does not authorize an FHC with Physical Commodity Trading authority to take and make delivery of the Proposed Commodities.

commodities that the Board has not yet evaluated. In addition, preventing RBS from having the exclusive right to use an alteration facility should reduce RBS's exposure to the potential risks associated with operating commodity-altering facilities.

4. Risks of Proposed Physical Commodity Trading Activities. Permitting RBS to engage in the limited amount and types of Physical Commodity Trading described above does not appear to pose a substantial risk to RBS, depository institutions, or the U.S. financial system generally. RBS has made commitments relating to its Physical Commodity Trading that are designed to address the risks involved in the proposed activities. In addition to the commitments discussed above, RBS provided substantially the same commitments as those provided by other FHCs in connection with the Board's approvals of their proposals to engage in Physical Commodity Trading. In particular, RBS has committed to limit the total market value of all commodities that it will hold at any one time relating to its Physical Commodity Trading activities to 5 percent of its consolidated tier 1 capital (as calculated under its home country standard).[20] Additionally, RBS will notify the Federal Reserve Bank of Boston if the market value of commodities it holds as a result of its Physical Commodity Trading exceeds 4 percent of its tier 1 capital.

Energy Tolling

As noted, the Board has not previously determined that Energy Tolling is a complementary activity under section 4 of the BHC Act. For the reasons stated below, a number of considerations support the Board's determination that Energy Tolling is complementary to the financial activity of engaging in Commodity Derivatives Activities.

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[20] RBS would be required to include within this 5 percent limit the market value of any commodities held as a result of a failure of reasonable efforts to avoid taking delivery of derivatives contracts that RBS enters into under the authority for BHCs in section 225.28(b)(8)(ii)(B) of Regulation Y.

A. RBS's Proposed Energy Tolling Agreements

Under the energy tolling agreements that would be transferred to JV, SET, as toller, pays the plant owner a fixed periodic payment that compensates the owner for its fixed costs ("capacity payments"), usually monthly, in exchange for the right to all or part of the plant's power output. The plant owner, however, retains control over the day-to-day operations of the plant and physical plant assets at all times.[21] The toller provides (or pays for) the fuel needed to produce the power that it directs the owner to produce. The fuel and energy transactions that the toller enters into in these circumstances are generally physically settled.[22] The agreements also generally provide that the owner will receive a marginal payment for each megawatt hour produced by the plant to cover the owner's variable costs plus a profit margin. The toll is similar to a call option on the power produced by the plant with a strike price linked to fuel and power prices. In general, the toller would direct the operator to run the plant (i.e., the toller would exercise its option) when the price of power exceeds the cost of producing that amount of power. Some tolling agreements may also give the toller the right to a plant's excess capacity, which the toller may sell to the market or use to meet reliability obligations to the power grid.

B. Energy Tolling as a Complementary Activity

Energy Tolling is an outgrowth of the existing financial activity of engaging in Commodity Derivatives Activities. As part of its Commodity Derivatives Activities, an FHC may take a derivatives position in a commodity, including energy. Energy Tolling complements Commodity Derivatives Activities by allowing an FHC to

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[21] RBS has indicated that SET's tolling agreements are all medium term (generally two to five years), although some market participants enter into longer-term agreements. SET has not entered into longer-term contracts, however, because it can be difficult to hedge exposure over a longer period of time.

[22] Because an FHC would generally take or make physical delivery of fuel and electricity in connection with a tolling agreement, an FHC would need approval to engage in Physical Commodity Trading to engage in Energy Tolling.

hedge its own, or assist its clients to hedge, positions in energy. Engaging in energy tolling would also provide an FHC with additional information on the energy markets that would help the FHC manage its own commodity risks. The Board also notes that financial institution competitors of RBS that are not FHCs engage in tolling activities as part of their energy trading operations. Based on the foregoing and all other facts of record, the Board concluded that RBS's Energy Tolling complements its Commodity Derivatives Activities.

C. Risks of Energy Tolling

The primary risk to a toller is that the plant proves to be uneconomical to operate, which can occur when the cost of producing power is greater than the power's market price. In those cases, the toller has no ability to recover its capacity payments. To limit the potential safety and soundness risks of Energy Tolling, RBS has committed that it will limit the amount of its Energy Tolling activities. Currently, all Physical Commodity Trading activities are limited to a maximum of 5 percent of the FHC's tier 1 capital. RBS has committed to include the present value of its future committed capacity payments under an energy tolling agreement in calculating the value of commodities held by RBS under its Physical Commodity Trading authority to determine compliance with the cap of 5 percent of tier 1 capital. As a result, allowing RBS to engage in Energy Tolling would not increase the overall position that it may take in physical commodities. This cap would also ensure that Energy Tolling remains limited in size and scope relative to RBS's financial activities.

Energy Management Services

RBS has requested that the Board permit it to expand its Commodity Derivatives Activities and Derivatives Advisory Services in the United States to include providing Energy Management Services pursuant to energy management agreements ("EMA") with plant owners. Under the EMAs to which SET is a party, the energy manager (SET) provides transactional and advisory services to power plant owners. The transactional services consist primarily of SET acting as a financial intermediary, substituting its credit and liquidity for those of the owner to facilitate the owner's purchase of fuel and sale of power. SET's advisory services include providing market information to assist the owner in developing and refining a risk-management plan for the plant. SET also provides a variety of administrative services to support these transactions.

The Board previously has determined that providing Energy Management Services complements the financial activities of Commodity Derivatives Activities and Derivatives Advisory Services.[23] Energy Management Services would complement RBS's current Commodity Derivatives Activities and Derivatives Advisory Service by allowing RBS to offer power plant owners certain agency and administrative services that would provide a power plant owner with an integrated approach to managing the commodity-related aspects of its business. The Energy Management Services that RBS proposes to provide do not differ in any significant way from the services that the Board previously approved. Furthermore, RBS has made all the required commitments that generally limit the scope of the activities that it may perform as energy manager to ensure that RBS is only taking on risks consistent with the agency nature of the Energy Management Services and limits the revenues attributable to RBS's Energy Management Services to 5 percent of RBS's total consolidated operating revenues.[24]

Granting RBS the authority to act as energy manager would not expand its ability to engage in physical commodity trading beyond what it can do as part of its proposed Physical Commodity Trading. The potential risks of providing Energy Management Services are already largely mitigated by the limits imposed on RBS's Commodity Derivatives Activities and Physical Commodity Trading.

<u>Risks and Public Benefits of the Proposed Activities</u>

As noted, to authorize RBS to engage in a complementary activity, the Board must determine that the activity does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally. Moreover, the

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[23] <u>Fortis S.A./N.V.</u>, 94 Federal Reserve Bulletin C20 (2008).

[24] "Total operating revenues" is defined as net interest income and all non-interest revenue, including net securities gains but excluding extraordinary items.

Board previously has stated that complementary activities should be limited in size and scope relative to an FHC's financial activities.

Permitting RBS to engage in the proposed complementary activities of Physical Commodity Trading, Energy Tolling, and Energy Management Services in the limited amounts and situations described above would not appear to pose a substantial risk to RBS, depository institutions, or the U.S. financial system generally. The commitments described above and in the appendix should help limit the safety and soundness risks, size, and scope of the proposed activities. RBS may already incur the price risk of commodities under its existing Commodity Derivatives Activities, and none of the proposed activities would appear to increase its potential exposure to that risk. In addition, RBS would remain subject to the securities, commodities, and energy laws and to the applicable rules and regulations (including the anti-fraud and anti-manipulation rules and regulations) of the CFTC and the Federal Energy Regulation Commission.

The Board believes that RBS has the managerial expertise and internal control framework to manage the risks of engaging in Physical Commodity Trading, Energy Tolling, and Energy Management Services. RBS has shown it has the expertise and internal controls necessary to effectively integrate the risk management of those activities into its overall risk-management framework.

The Board must also determine that the performance of these complementary activities by RBS "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices." Approval of the request to engage in Physical Commodity Trading, Energy Tolling, and Energy Management Services likely would benefit RBS's customers by enhancing RBS's ability to provide efficiently a full range of commodity-related services consistent with existing market practice. Approval also would enable RBS to improve its understanding of physical commodity and commodity derivatives markets and its ability to serve as an effective competitor in those markets. In addition, engaging in Energy Tolling would allow RBS to provide risk-intermediation services to clients whose businesses involve significant energy commodity risks. Energy Tolling also would allow RBS to participate more fully in Physical Commodity Trading by securing a source for its physically settled electricity derivatives contracts and to employ tolling agreements as part of its own hedging strategies or those of its clients.

RBS's Physical Commodity Trading, Energy Tolling, and Energy Management Services should not result in an undue concentration of resources or other adverse effects on competition because the market for these services is regional or national in scope. Any potential conflicts of interests associated with RBS's activities should be mitigated by the anti-tying provisions in section 106 of the Bank Holding Company Act Amendments of 1970.

For these reasons, and based on RBS's policies and procedures for monitoring and controlling the risks of the activities, the Board concludes that allowing RBS to engage in Physical Commodity Trading, Energy Tolling, and Energy Management Services on the limited bases described above does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally and can reasonably be expected to produce benefits to the public that outweigh any potential adverse effects.

Conclusion

Based on all the facts of record, including the representations and commitments made by RBS to the Board in connection with the notice, and subject to the terms and conditions set forth in this order, the Board has determined that the notice should be, and hereby is, approved. The Board's determination is subject to all the conditions set forth in Regulation Y and to the Board's authority to require modification or termination of the activities of a BHC or any of its subsidiaries as the Board finds necessary to ensure compliance with, or to prevent evasion of, the provisions and purposes of the BHC Act and the Board's regulations and orders issued thereunder. The Board's decision is specifically conditioned on compliance with all the commitments made in connection with the notice, including the commitments and conditions discussed in this order. The commitments and conditions relied on in reaching this decision shall be deemed to be conditions imposed in writing by the Board in connection with its findings and decision and, as such, may be enforced in proceedings under applicable law.

By order of the Board of Governors,[25] effective March 27, 2008.

(signed)

Robert deV. Frierson
Deputy Secretary of the Board

[25] Voting for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Warsh, Kroszner, and Mishkin.

Appendix

Commitments by RBS

RBS, together with its subsidiaries (collectively, "RBS"), commits with respect to the notice ("Notice") it has filed with the Board to engage in Physical Commodity Trading, Energy Tolling, and Energy Management Services in the United States or by an entity located in the United States that:

1. RBS will conduct its Physical Commodity Trading, Energy Tolling, and Energy Management Services exclusively pursuant to the authority of section 4 of the BHC Act and in accordance with the limitations that the Board has placed on the conduct of such activities, and will not conduct such activities in the United States in reliance on section 2(h)(2) of the BHC Act or section 211.23(f)(5) of the Board's Regulation K.

<u>Physical Commodity Trading Activities</u>

2. RBS will limit the aggregate market value of physical commodities that it holds at any one time as a result of Physical Commodity Trading to 5 percent of its tier 1 capital. RBS will include in this 5 percent limit the market value of any physical commodities it holds as a result of a failure of reasonable efforts to avoid taking delivery in commodities transactions conducted pursuant to section 225.28(b)(8)(ii)(B) of Regulation Y. In addition, RBS agrees to notify the Federal Reserve Bank of Boston if the aggregate market value of commodities held under this approval exceeds 4 percent of RBS's tier 1 capital.

3. RBS will take and make physical delivery only of physical commodities for which derivative contracts have been authorized for trading on a U.S. futures exchange by the Commodity Futures Trading Commission ("CFTC") or physical commodities of which the Board has specifically authorized RBS to take and make physical delivery (collectively, "Approved Commodities").

4. RBS will enter into long-term electricity supply contracts only with large commercial and industrial end-users that consume electricity at a rate of at least (i) 800 megawatt-hours/year or (ii) the minimum consumption level for large commercial and industrial customers under applicable state law, whichever is greater.

5. RBS will not use this authority to own, invest in, or operate facilities for the extraction, transportation, storage, or distribution of commodities but will only

use storage and transportation facilities owned and operated by third parties. RBS will enter into service agreements only with reputable independent third-party facilities.

6. RBS will conform to the requirements of the BHC Act, including by divestiture if necessary, the activities of (i) owning, investing in, or operating storage facilities for commodities that it is not permitted to hold or store under the BHC Act and (ii) making and taking physical delivery of commodities that are not Approved Commodities, including metal concentrates, acquired in connection with the transactions contemplated by the Notice within two years of consummation of the transactions, or such longer period as the Federal Reserve in its discretion may grant.

7. After consummation of the transactions contemplated by the Notice, RBS will not expand its direct or indirect activities or investments in the activities of (i) owning, investing in, or operating storage facilities for commodities that it is not permitted to hold or store under the BHC Act and (ii) making and taking physical delivery of commodities that are not Approved Commodities, including metal concentrates. RBS will not expand these activities or investments beyond those engaged in by the SET Companies immediately prior to the date of the consummation of the proposed transaction by directly or indirectly (i) acquiring direct control of a company engaged in any activity, or acquiring any assets or business lines of another company that engages in impermissible activities, (ii) increasing the types of investments, products, or services to be engaged in or provided by RBS, or (iii) any similar transactions that would result in an expansion of these activities.

8. RBS will act solely as an intermediary in the physical commodities market and will not process, refine, or otherwise alter a physical commodity itself. RBS will contract with a third party for any services it needs in connection with the handling of any commodity. RBS further commits that it will not contract for the exclusive right to use a facility to alter commodities for any period of time. Consistent with the Physical Commodity Trading authority, RBS will contract with third parties (i) to alter only an Approved Commodity and (ii) to alter the commodity only into another Approved Commodity.

Energy Tolling

9. RBS will include the present value of all capacity payments to be made by RBS in connection with energy tolling agreements in calculating its compliance with the limit of 5 percent of tier 1 capital on the aggregate market value of the physical commodities that it and any of its subsidiaries hold at any one time as a result of Physical Commodity Trading.

Volumetric Production Payment Transactions

10. RBS will include any commodities that RBS receives under a volumetric production payment transaction and does not immediately sell to a third party in calculating its compliance with the limit of 5 percent of tier 1 capital on the aggregate market value of the physical commodities that it and any of its subsidiaries hold at any one time as a result of Physical Commodity Trading.

Energy Management Services

11. Revenues attributable to RBS's Energy Management Services in the United States will not exceed 5 percent of its total consolidated operating revenues.[26]

12. RBS will only act as energy manager in the United States if the energy management agreement under which it performs its Energy Management Services provides that:

    a. The owner of the facility retains the right to market and sell power directly to third parties, which may be subject to the energy manager's right of first refusal;

    b. The owner of the facility retains the right to determine the level at which the facility will operate (i.e., to dictate the power output of the facility at any given time);

    c. Neither the energy manager nor its affiliates guarantee the financial performance of the facility; and

    d. Neither the energy manager nor its affiliates bear any risk of loss if the facility is not profitable.

RBS agrees that the foregoing commitments are deemed to be conditions imposed in writing by the Board in connection with its findings and decision on the notice filed by RBS to engage in Physical Commodity Trading, Energy Tolling, and Energy Management Services under section 225.89 of Regulation Y and, as such, may be enforced in proceedings under applicable law.

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[26] Total operating revenues are defined as net interest income and all non-interest revenue, including net securities gains but excluding extraordinary items.