



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ
GENERAL COUNSEL

May 15, 2006

Elizabeth T. Davy, Esq.
Sullivan & Cromwell LLP
125 Broad Street
New York, NY 10004-2498

Dear Ms. Davy:

This is in response to your request on behalf of UBS AG (“UBS”), Zurich, Switzerland, requesting confirmation that certain volumetric production payment (“VPP”) transactions involving physical commodities are extensions of credit permissible for a bank holding company under section 225.28(b)(1) of the Board’s Regulation Y.¹ In 2004, the Board approved a proposal by UBS to engage in physical commodity trading as an activity that is complementary to UBS’s commodity derivatives activities.² The Order limited the value of physical commodities that UBS may hold under this authority to five percent of UBS’s tier 1 capital. You have further requested confirmation that VPP transactions and any physical commodities delivered to UBS under a VPP would not count against this five percent of tier 1 capital limit.

A VPP is a royalty interest, typically in a hydrocarbon (such as oil or natural gas) reserve that entitles the VPP holder, in exchange for an upfront payment, to receive specified quantities of hydrocarbons on a regular basis during the life of the VPP transaction. A VPP is considered a real property interest in most states. Relying on its physical commodity trading authority, UBS has already entered into two VPP transactions in the United States. In each of these transactions, a wholly owned, consolidated, U.S. special purpose

¹ 12 CFR 225.28(b)(1).

² See UBS AG, 90 Federal Reserve Bulletin 215 (2004) (“Order”).

vehicle subsidiary of UBS (the “SPV”) has acquired a VPP from a hydrocarbon producer (the “customer”) in exchange for cash.³ The VPP transactions are designed to provide funding to the customers. The VPP does not give UBS the right to control production of the oil or gas, and UBS is therefore dependent on the customer meeting its contractual obligation to produce the agreed upon volume of oil or gas according to the agreed upon schedule.

Simultaneously with its purchase of the VPP interest from the customer, the SPV and UBS enter into an agreement under which UBS makes an upfront payment to the SPV and the SPV agrees to deliver to UBS the volumes of oil or gas to be received by the SPV from the customer under the VPP. As the SPV delivers the oil or gas to UBS under this agreement, UBS arranges to sell it, either back to the customer or into the marketplace, at the then-current market price for the commodity.

UBS may also decide temporarily to retain hydrocarbons it acquires pursuant to a VPP in order, for example, to take advantage of an anticipated rise in price for the relevant commodity. UBS has agreed that any hydrocarbons acquired under a VPP will be counted against UBS’s five percent of tier 1 capital limit under the Order if they are not immediately sold to a third party. UBS has represented that it hedges its commodity price risk from the VPP by entering into a fixed-rate commodity swap with a third party (which may be the customer) that converts UBS’s variable proceeds from the periodic sale of the oil or gas into fixed-rate payments. Accordingly, in the absence of counterparty defaults, by the end of the VPP term UBS will have recouped the original amount advanced to the customer plus a fixed return.

UBS has stated that the VPP transactions generally are treated as loans for U.S. federal income tax purposes. In addition, UBS has indicated that it will treat VPP transactions as loans for accounting purposes. Board staff expects that UBS will follow generally accepted accounting principles in reporting any VPP transactions, and that all of UBS’s VPP transactions will be entered into for legitimate business purposes.

You have argued that a VPP transaction is very similar to a traditional lending arrangement because the discounted present value of the hydrocarbons to be delivered to UBS over the life of a VPP transaction is

³ [TEXT REDACTED]

estimated to equal the purchase price paid by UBS for the VPP interest plus a margin meant to cover UBS's cost of funds, risk associated with the transaction, and a fixed profit. Importantly, the VPP does not give UBS any variable upside potential if there is excess production from the producer's hydrocarbon reserve.⁴ Moreover, the commodity price swap hedges UBS's commodity price risk associated with the VPP, thus guaranteeing UBS a return of principal and a fixed amount of interest if neither the producer nor the swap counterparty defaults. Accordingly, the VPP transactions are not designed to serve as a vehicle for UBS to take on commodity price risk, own commodities, or engage in commodity dealing.⁵

As described above, as part of a VPP transaction, UBS will hold a royalty interest in a hydrocarbon reserve and will periodically take title, if only momentarily, to physical commodities. The Board has previously concluded, however, that ownership of commodities in connection with a financing transaction does not prevent the transaction from being treated as a form of credit extension permissible for a bank holding company if the economics of the transaction are substantially the same as those of a loan.⁶

Based on the information you have provided, it is my opinion that the VPP transactions described above are a form of permissible lending activity for bank holding companies under section 225.28(b)(1) of Regulation Y when entered into for the purpose of providing financing to a third-party customer.

⁴ If the reserve produces more hydrocarbons than are subject to the VPP, the production is for the benefit of the producer. If the reserve under-produces in a given period during the life of the VPP, UBS would be entitled to an appropriate amount of overproduction in subsequent months (and extra reimbursement to reflect default interest).

⁵ As noted above, UBS has the authority to engage in physical commodity trading, including making and taking delivery of physical commodities, and may use this authority to retain ownership of hydrocarbons delivered under a VPP in order to benefit from anticipated changes in hydrocarbon prices.

⁶ See Chemical New York Corporation, 59 Federal Reserve Bulletin 698 (1973). See also letters from Robert J. Herrmann, Deputy Comptroller of the Currency (October 4, 1994) (unpublished) and Horace G. Sneed, Senior Attorney, Office of the Comptroller of the Currency (November 4, 1994) (unpublished).

Any commodities that UBS receives pursuant to a VPP transaction and that are not sold immediately to third parties would be subject to the five percent of tier1 capital limit on the value of commodities that UBS may hold under its physical commodity trading authority.

UBS should have in place policies and procedures to identify whether a VPP transaction would create heightened legal or reputational risk to UBS, and to manage any such risk. In particular, UBS should have policies and procedures to identify whether a particular VPP transaction lacks economic substance or business purpose; may be designed by the counterparty for questionable accounting, regulatory, or tax purposes; or may be accounted for or disclosed by the counterparty in a way that is misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements.

This opinion is limited solely to the permissibility of the VPP transactions described above under Regulation Y and does not address the permissibility of any other activities or authorize UBS to engage in any other activities in the United States. Any material change in the manner in which UBS conducts VPP transactions could result in a different conclusion and should be reported promptly to Board staff. If you have any questions about this matter, please contact Mark E. Van Der Weide (202/452-2263) or Andrew S. Baer (202/452-2246) of the Board's Legal Division.

Sincerely,

(signed)

Scott G. Alvarez

cc: Federal Reserve Bank of New York