

Federal Reserve Expands Energy Trading Authority of The Royal Bank of Scotland Group plc

April 2, 2008

On March 27, 2008, the Federal Reserve Board (the "Federal Reserve") issued an order authorizing The Royal Bank of Scotland Group plc ("RBS") to expand its commodities trading businesses in connection with the formation of a joint venture with Sempra Energy involving Sempra Energy's energy and other commodities trading subsidiaries. In addition to approving physical commodity trading, which involves entering into contracts that may require making or taking physical delivery of or storing commodities, the Federal Reserve's order for the first time permits a financial holding company to enter into energy tolling arrangements, and the order approves new and expanded authority to engage in physical energy trading activities as well as the provision of energy management services.

RBS is a financial holding company regulated by the Federal Reserve under the Bank Holding Company Act and related regulations. This order highlights the Federal Reserve's recognition that energy trading markets have developed into very sophisticated financial markets, that banking organizations and other financial institutions are playing an increasingly important role in the trading of energy commodities, and that financial holding companies need to participate in the expanding financial markets for such commodities to meet customers' demands and to compete effectively with other financial firms. Key provisions of the Federal Reserve's order are summarized below.

As a result of the Federal Reserve's ruling, on April 1, 2008, RBS and Sempra Energy completed the formation of their international commodities joint venture, named RBS Sempra Commodities, LLP. This joint venture uniquely combines an industry leading commodities trading operation with one of the world's leading financial institutions. RBS holds a 51% interest in this joint venture and retains management control over the underlying businesses through various agreements and the right to appoint a majority of the joint venture's board.

Simpson Thacher & Bartlett LLP's Energy and Infrastructure Group, together with our Banking, Corporate, Tax and Regulatory groups, represented RBS in all aspects of this transaction, including before the Federal Reserve and Federal Energy Regulatory Commission.

PHYSICAL COMMODITIES TRADING

The Federal Reserve has since 2003 authorized financial holding companies and their subsidiaries, upon obtaining the specific approval of the Federal Reserve, to engage in physical commodities trading as a complement to their financial, commodities derivatives activities. However, in its recent order, the Federal Reserve expanded the scope of these permissible activities to allow RBS to engage

in the wider range of activities that are engaged in by Sempra Energy's commodities trading subsidiaries (which now operate through the joint venture).

In particular, RBS is the first financial holding company authorized to enter into long-term electric supply contracts with large commercial and industrial customers, subject to certain limitations on the definition of such customers and permissible transactions. RBS also is authorized to engage in physical trading of a broader range of commodities than has been previously approved for other financial holding companies, which have been limited to physical trading only in commodities for which derivatives contracts are approved by the Commodity Futures Trading Commission ("CFTC"). The list of additional commodities that RBS may trade on a physical basis was expanded to include the following non-CFTC approved commodities: nickel, certain natural gas liquids, oil products and petrochemicals. This expansion was approved based on RBS' showing that these commodities are traded on established alternative trading platforms, are fungible and are traded in sufficiently liquid markets. RBS also is permitted, for the first time, to enter into arrangements with third parties to refine, blend and otherwise alter commodities for which it is permitted to take physical delivery, subject to certain requirements.

In approving these new and expanded physical commodities trading activities, RBS committed to limit the total market value of all commodities that it will hold at any one time relating to its physical commodities trading activities in the United States to 5% of its consolidated Tier 1 capital.

ENERGY TOLLING

In its order, the Federal Reserve for the first time determined that energy tolling activities were permissible for a financial holding company as complementary to a financial activity. Under a typical energy tolling arrangement, the energy trader agrees to pay a fixed periodic payment to the owner of a plant in exchange for the right to all of the plant's output. Under this arrangement, the plant's owner retains control over the operation of the plant, while the energy trader provides all necessary fuels and/or other inputs to the plant and is entitled to all of the plant's commodity output, in exchange for additional marginal payments usually calculated to permit the plant's owner to recover its variable costs plus some profit margin. The Federal Reserve determined that such tolling arrangements are an outgrowth of financial trading, akin to a call on the plant's output. As part of this authorization, RBS committed to include the present value of its future committed capacity payments under any energy tolling agreements in calculating the value of commodities held for physical trading in accordance with the 5% cap (as discussed above).

ENERGY MANAGEMENT SERVICES

The Federal Reserve's order also expanded RBS' permissible activities to include entering into energy management agreements with plant owners. Under these agreements, the energy manager provides transaction and other advisory services to a plant owner, generally acting as a financial intermediary to facilitate the owner's purchase and sale of commodities -- namely, the purchase of fuel and the sale of energy output. The Federal Reserve determined that these activities did not

differ in any significant way from financial activities, such as derivatives advisory services, previously approved by the Federal Reserve. RBS committed to limit revenues associated with such energy management services to 5% of its total consolidated operating revenues.

CONCLUSION

The Federal Reserve's order, permitting the consummation of RBS' joint venture with Sempra Energy, significantly expands the energy trading activities that the Federal Reserve has determined are complementary to a financial activity.

This memorandum is for general information purposes and should not be regarded as legal advice. If you have any questions about the Federal Reserve's order, please contact your relationship partner at Simpson Thacher; John Walker (212-455-7365; jwalker@stblaw.com) of our Banking Group; or David Lieberman (212-455-3545; dliberman@stblaw.com) or Brian Chisling (212-455-3075; bchisling@stblaw.com) of our Energy and Infrastructure Group. The names and office locations of all our partners, as well as memoranda regarding other legal developments and updates, can be obtained from our website, www.simpsonthacher.com.