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## *Public Utility Commission of Texas*

April 13, 2012

By: electronic submission

David A. Stawick  
Secretary of the Commission  
Commodities Future Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, NW  
Washington, D.C. 20581

**Re: Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds – Proposed Rules to Implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (RIN 3038-AD05)**

Dear Madams and Sirs:

On behalf of the Public Utility Commission of Texas (Texas PUC or PUCT), I appreciate the opportunity to comment on the proposed rule (the Proposal)<sup>1</sup> put forward by the Commodities Futures Trading Commission (CFTC). On February 13, 2012, I filed similar comments, on behalf of the PUCT, on the proposed rule issued by the U.S. Department of the Treasury's Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and the U.S. Securities and Exchange Commission (with the CFTC, collectively the Agencies) (Joint Rule).<sup>2</sup> The Proposal and the Joint Rule seek to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act or the Act).<sup>3</sup> The CFTC adopted the entire text of the Joint

<sup>1</sup> *Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Covered Funds*, 77 Fed. Reg. 8332 – 8447 (Feb. 14, 2012) (to be codified as 17 CFR Part 75) (Proposal).

<sup>2</sup> *Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds*, 76 Fed. Reg. 68846 – 68972 (Nov. 7, 2011) (to be codified as 17 CFR Part 255) (Joint Rule).

<sup>3</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010)

Rule as part of the Proposal, but modified the Joint Rule with CFTC-specific rule text, added CFTC-specific questions and did not include Subpart E of the Joint Rule because it deals exclusively with the Board.<sup>4</sup> Therefore, my comments on the Proposal are largely the same as those I filed on the Joint Rule.

For the reasons explained in more detail below, the Texas PUC is concerned that the wholesale and retail power markets within the Electric Reliability Council of Texas, Inc. (ERCOT) are likely to be materially and adversely effected from the approach taken by the Agencies. Accordingly, before final rules are adopted we believe that significant changes to the Proposal, and the Joint Rule, will be necessary, particularly with respect to the provisions implementing the market-making exemption contained in the Dodd-Frank Act.

### **Background**

The Texas PUC is responsible for protecting the public interest inherent in the rates and services of public utilities,<sup>5</sup> which includes but is not limited to ensuring (1) that electric rates, operations and services are just and reasonable to and for Texas consumers and Texas electric utilities,<sup>6</sup> (2) that Texas electric utilities and electric cooperatives furnish service, instrumentalities and facilities that are safe, adequate, efficient and reasonable,<sup>7</sup> and (3) that electric utilities and transmission and distribution utilities provide reliable electric service throughout Texas.<sup>8</sup> Furthermore, within ERCOT the Texas Legislature has found “that... the public interest in competitive electric markets requires that...electric service and their prices should be determined by customer choice and the normal forces of competition.”<sup>9</sup> The Texas PUC also oversees ERCOT, the independent system operator for the electric grid, and the unbundled and restructured energy-only electricity market operated on that grid. The ERCOT grid covers approximately 75% of the State’s land mass and 85% of its electric load. Finally, within the ERCOT region the PUCT is responsible for preventing market manipulation and other forms of market power abuse.<sup>10</sup>

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<sup>4</sup> Proposal at 8332.

<sup>5</sup> Public Utility Regulatory Act, TEX. UTIL. CODE ANN. § 11.002 (Vernon 1998 & Supp. 2011) (PURA).

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* at § 38.001.

<sup>8</sup> *Id.* at §§ 39.352(b) and 39.356(a).

<sup>9</sup> PURA § 39.001.

<sup>10</sup> *Id.*, at 39.157; *see also* P.U.C. SUBST. R. 25.93.

Central to the efficient operation of the wholesale and retail power markets within the ERCOT region are the ERCOT administered (1) day-ahead market, (2) real-time market and (3) auction of its congestion revenue rights (CRRs). CRRs, which are ERCOT's form of financial transmission rights, are used to hedge against price differences caused by transmission constraints. Banks and their affiliates are active participants in the ERCOT markets. The Texas PUC is concerned that if the Proposal is adopted as written, banks will sharply curtail their activity or even cease to participate in various ERCOT related markets, resulting in reduced liquidity in those markets.

### **General Concern**

The PUCT believes it is crucial that the rules required by the Dodd-Frank Act be implemented in a manner that does not disrupt the liquidity necessary for functioning power markets and impose potentially prohibitive costs and burdens on market participants who need to build, operate, sell and buy electric power and, therefore, need to hedge various financial and physical risks relating to those activities. As noted in ERCOT's comment letter on the Joint Rule:

Banking entities are significant participants in the ERCOT market. ERCOT market participants include such well-known banking-related entities as Barclays Bank PLC, Credit Suisse Energy LLC, JPMorgan Ventures Energy Corporation, and Morgan Stanley Capital Group, Inc. Banking entities play several roles in the ERCOT market. These include traditional project finance, in which banking entities provide financing and hedging transactions that support the development of generation and transmission resources that are vital to reliable delivery of electricity. The ERCOT market relies on being attractive to those who are positioned to make the large, long-term investments that ensure Texas has enough power to support a growing population and vibrant economy. These investments are increasingly vital as ERCOT regularly sets records for electricity demand, and faces uncertainties in maintaining adequate supply of power (ERCOT's Comments).<sup>11</sup>

The Texas PUC supports and joins in the comments submitted by ERCOT and urges that the CFTC give serious consideration to the concerns raised by ERCOT in their comment letter.

### **Specific Concerns and Issues**

The Proposal generally prohibits a covered banking entity from acting as principal in the purchase or sale of a covered financial position for its own trading account. The Proposal

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<sup>11</sup> See ERCOT Comments at 5 (April 11, 2012).

creates a presumption that any account that holds a covered financial position for a period of sixty days or less is a trading account and such transactions are presumptively prohibited.<sup>12</sup> While the Proposal allows this presumption to be rebutted, that may be risky legally and covered banking entities may seek to avoid the risk either by disposing of such positions as quickly as possible in order to avoid suspect transactions or withdrawing from the market entirely. Yet, organized wholesale power markets, especially commercial end-user market participants (including power plant developers, owners and operators), need market-makers to intermediate risk and provide liquidity. In order to serve this function, banks and their affiliates, as market-makers, need flexibility to warehouse positions, enter into wholesale power transactions and hedge the risks of time, deliverability and other market forces such as fuel prices. Deep, liquid and efficient power markets depend upon financial counter-parties for these services. Rigid implementation of the Proposal could artificially limit market-makers' ability to intermediate risk – potentially decreasing liquidity and creating inefficiencies and higher prices for wholesale market participants and, ultimately, retail electricity customers. Such outcomes could also have unintended second order effects on the ability of generation developers to raise capital and secure financing.

Hedging is an essential financial transaction in the ERCOT market. For a simple example, many retail electric customers in ERCOT, particularly residential and small commercial customers, enter into fixed-rate contracts with their retail electric providers (REPs) that have terms ranging from three months to three years. In order for REPs and other load-serving entities (including distribution-only municipally-owned utilities) to be able to offer locked-in fixed-rate electricity prices, each party to the wholesale transaction must be able to hedge their respective risk. Load-serving entities need to be able to mitigate power price volatility by entering into bilateral forward contracts for power that give them price stability. Smaller REPs often rely upon financial institutions to provide arrangements enabling the REPs to be credit-worthy counterparties to their power providers. In turn, generators must be able to hedge their fuel costs and delivery risks. Generators' delivery risks include both transmission congestion risk as well as the physical power supply risk of covering power short-falls resulting from plant failures by purchasing replacement power in the real-time market.

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<sup>12</sup> Proposal at 8345.

The market-making exemption in the Proposal appears to be predicated on the incorrect assumption that there is a perfect hedge and that all risks can be hedged for any given holding period for any position.<sup>13</sup> But it is impossible to predict what the behavior of even the most highly correlated hedge will be versus the underlying asset being hedged. The realization of some profit or loss is unavoidable. Because under the Proposal each trade is looked at individually, there is an even greater chance that a covered banking entity could be deemed to have engaged in a prohibited activity. Therefore the Texas PUC is concerned that banking entities may choose not to participate in this market-making role for fear of engaging in prohibited activities.

While Section 619 of the Act generally prohibits any “covered banking entity” from engaging in “proprietary trading,” there are certain statutory exceptions.<sup>14</sup> The legislation specifically provides an exemption for “[t]he purchase, sale, acquisition, or disposition of securities and other instruments . . . in connection with underwriting or market-making activities.”<sup>15</sup> The PUCT is concerned that the Proposal fails to give sufficient deference to this exemption because it does not establish a broad standard or framework that gives parties sufficient guidance as to what constitutes permitted market-making activities, particularly in organized power markets. Instead, the Proposal creates a presumption that any “covered financial position” that a “covered banking entity” holds for a period of sixty days or less is a “prohibited proprietary transaction,” and then provides a framework for rebuttal that is difficult to see as workable.<sup>16</sup>

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<sup>13</sup> *Id.* at 8358, 8360-2 (explaining that certain hedging transactions related to market-making positions and holdings will also be deemed to be made in connection with a banking entity’s market making-related activities for purposes of the market-making exemption if they meet certain requirements; i.e. that the purchase or sale is conducted in order to reduce the specific risks to the banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings acquired pursuant to the market-making exemption and that the hedging transaction meet the criteria specified in the general exemption for risk-mitigating hedging activity for purposes of the proprietary trading prohibition).

<sup>14</sup> Act §§ 13(a)(1) and (h)(4) (defining the term “proprietary trading” when used with respect to a banking entity or nonbank financial company supervised by the Board to mean engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine.).

<sup>15</sup> *Id.* at § 13(d) (listing permitted activities); see also § 13(b) (v).

<sup>16</sup> Proposal at 8345.

The proposed structure of market-making permitted activity in the Proposal is too narrow and prescriptive.<sup>17</sup> The Proposal has specific criteria that apply equally across all asset classes and market conditions, each of which must be met in order for an activity to qualify as permissible market making.<sup>18</sup> Most important to electric power markets, the Proposal does not provide an exemption for unregulated over-the-counter (OTC) market-making activities by covered banking entities. If banking-entity market-makers are essentially prohibited from holding inventory because of the Proposal, this restriction will be reflected in the ability of market-makers to provide both liquidity and certainty as to transaction costs for participants in organized power markets. This limitation will result in higher and more volatile electric prices to end-use customers.

The CFTC should adopt a less rigid structure that focuses on general guidelines rather than strict criteria that must be met. At a minimum, different criteria should be developed for market-making activities in organized power markets. For example, the criteria that should be reconsidered include, but are not limited to:

**Two-sided markets on a *regular or continuous basis*<sup>19</sup> – may not be applicable in all markets.**

- *Example:* A highly structured, negotiated transaction with a power plant owner to hedge its fuel and/or power production price risk presents a classic example of a client-facing, market-making activity that is both initiated by, and beneficial to, clients. However, this type of transaction may not meet the criteria for regular or continuous quoting.

**Activities of a trading unit must be designed to generate revenues *primarily from fees, commission, and bid/ask spreads, or other income not attributable to appreciation in value of covered financial positions*<sup>20</sup> – ignores the fact that market-makers must hold inventory, which may increase or decrease in value, until a buyer appears.**

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<sup>17</sup> *Id.* at 8355-8.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 8355 (explaining that the core element of the statutory market-making exemption is that the activity must be market-making related, and in order to give effect to this requirement the trading desk or other organizational unit that purchases or sells a particular covered financial position to hold itself must hold itself out as being willing to buy and sell, or otherwise enter into long and short positions in, the covered financial position, for its own account on a regular or continuous basis).

<sup>20</sup> *Id.* at 8358.

- *Example:* Market-makers will offer more for a tolling agreement<sup>21</sup> if they know that they can hold the associated risk until a buyer appears for the other side of the trade. If the trader is required to hedge that tolling agreement within an artificially fixed time-period, it will naturally pay significantly less to acquire the tolling agreement, shifting time risk back to the client.

For many reasons, including those listed in this letter, the Proposal will discourage, if not effectively prohibit, market-makers from holding certain positions like CRRs, thus reducing liquidity and increasing the costs to end-users for those transactions. Similarly, the Proposal will discourage market-makers from holding positions in wholesale power (or natural gas) contracts, thus, reducing liquidity and increasing the costs for those transactions.

### **Conclusion**

A rulemaking of this magnitude and with so many uncertain consequences is too important to rush, especially because of the potential for damage to organized power markets like ERCOT, and ultimately the resulting cost impact on retail electric consumers. At the very least, the PUCT respectfully requests that the Proposal be re-published for additional comment after the CFTC has had time to consider all of the comments which are submitted by interested parties and determined the scope and details of the rules. This is advisable so that interested parties can focus on the particular technical problems that may still exist while there is still time for the CFTC to address them. In addition, once the CFTC has finalized the rules, the compliance deadlines should be extended, and the requirements should be phased in over time, not all at once. A gradual phase in will allow regulators such as the Texas PUC and organized power market participants to consider how to adjust and to implement the final rules in an orderly manner so as to avoid, or at least mitigate, the risks of market disruption.

If the Proposal is adopted in its current form, it can reasonably be expected that covered banking entities will be forced to curtail severely their traditional market-making activities in the ERCOT market. The short time frame provided for the covered banking entities to implement the Act is likely to result in a material reduction in liquidity in the marketplace, and the Texas

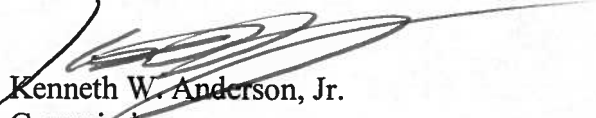
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<sup>21</sup> A “tolling agreement” can be described as a call on power with a gas-linked strike price, or a temporary contract between the permanent owner of a generation asset and another agent that allows that agent to claim ownership and management of the output at certain times, much like a rental agreement.

PUC is concerned that there may not exist enough capacity among nonbank market-makers to provide the necessary liquidity to the ERCOT market if covered banking entities are forced to abandon the market.

The Texas PUC respectfully, but strongly, urges the CFTC to re-think the approach taken in the Proposal by addressing the points raised in this letter, and in ERCOT's Comments, in order to create a regulatory framework that accomplishes the narrow mandate of Section 619 of the Dodd-Frank Act, to prohibit speculative proprietary trading by covered banking entities, without adversely affecting the efficient functioning of organized power markets. The PUCT thanks the CFTC for their consideration of our comments.

Very truly yours,



Kenneth W. Anderson, Jr.  
Commissioner