

October 9, 2012

Via Email Submission

Sauntia Warfield
Assistant Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street N.W.
Washington, DC 20581

Re: Notice of Proposed Order and Request for Comment on a Petition From Certain Independent System Operators and Regional Transmission Organizations

Dear Ms. Warfield:

On behalf of our client, Petitioner Electric Reliability Council of Texas, Inc. (“ERCOT”), we respectfully submit the following supplement to ERCOT’s September 27, 2012 comments on the Commodity Futures Trading Commission’s (“CFTC” or “Commission”) proposed order to exempt certain transactions in the Independent System Operator (“ISO”) or Regional Transmission Organization (“RTO”) markets.¹

The Commission issued the Proposed Order in response to Petitioners’ consolidated requests for an exemption (“Exemption Request”) from all but the anti-manipulation and anti-fraud provisions of the Commodity Exchange Act, as amended (“CEA”) filed with the Commission on February 7, 2012, as updated on June 11, 2012. ERCOT submits these supplemental comments to demonstrate that the Commission should exercise its statutory authority, under section 4(c)(3)(K) of the CEA, to find that all ERCOT eligible market participants are “appropriate persons” “in light of their financial or other qualifications, or the applicability of appropriate regulatory protections.”²

The Commission should deem all market participants that qualify to transact in the ERCOT markets as “appropriate persons” because:

¹ Proposed Order and Request for Comment on a Petition From Certain Independent System Operators and Regional Transmission Organizations To Exempt Specified Transactions Authorized by a Tariff or Protocol Approved by the Federal Energy Commission or the Public Utility Commission of Texas From Certain Provisions of the Commodity Exchange Act, 77 Fed. Reg. 52138 (Aug. 28, 2012) (the “Proposed Order”). Although ERCOT’s comments fall beyond the 30-day comment period, ERCOT requests that the Commission accept these comments.

² 7 U.S.C. 6(c)(3)(K).

- (1) The ERCOT Protocols establish stringent participant eligibility requirement to transact in the ERCOT markets, including annual certifications, financial eligibility requirements, and verification of a market participant's risk management policies and procedures. Many of these participant eligibility requirements are comparable to the requirements of the Federal Energy Regulatory Commission's ("FERC") credit reform order.³
- (2) The ERCOT Protocols impose significant credit requirements for all transactions in the ERCOT market.
- (3) The ERCOT markets are subject to pervasive market monitoring and regulatory oversight by the Public Utility Commission of Texas ("PUCT").⁴

I. Overview of the Proposed Order's Potential Limiting Effect on Current ERCOT Market Participants

ERCOT expects that the Commission's proposed categories of appropriate persons would exclude a number of market participants unnecessarily given the pervasive regulations at the wholesale and, with respect to retail electric providers, at the retail level, that effectively mitigate financial risk associated with such entities.

II. Participant Eligibility Requirements

The Commission should find that all market participants eligible to participate in the ERCOT markets are appropriate persons who can benefit from the Exemption Request. The Commission should base this determination, in part, on the fact that the ERCOT Protocols ensure participation by qualified market participants through significant market participant eligibility requirements, including annual certification, minimum capitalization (or alternative posting of an independent secured amount), and verification of a market participant's risk management policies and procedures.

The ERCOT Protocols establish extensive eligibility requirements for market participants.⁵ Counterparties may participate as Qualified Scheduling Entities ("QSEs") in the energy markets and as Congestion Revenue Rights Account Holders ("CRRAHs") in the

³ *Credit Reforms in Organized Wholesale Electric Markets*, Order No. 741, 133 FERC ¶ 61,060 (2010) ("FERC Order No. 741").

⁴ Many of the relevant ERCOT provisions were discussed in great detail in the Attachments to the joint Exemption Request and are incorporated by reference herein.

⁵ Section 16 of the ERCOT Protocols establishes registration and qualification requirements for all market participants.

financial transmission rights markets.⁶ The eligibility requirements include, in relevant part, the satisfaction of the following:

- Demonstrating the capability to perform the functions of a CRRAH or QSE;⁷
- Demonstrating the capability of complying with the requirements of all ERCOT Protocols and Operating Guides;⁸
- Satisfying all applicable credit requirements;⁹
- Demonstrating the ability to pay its debts as they come due (ERCOT may request evidence if ERCOT believes that a QSE or CRRAH is failing to comply with this requirement);¹⁰
- Providing bank account information and arrange for electronic system transfers for two-way confirmation;¹¹ and
- Assuming financial responsibility for all settlement charges under the ERCOT Protocols.¹²

Any entity is eligible to obtain QSE or CRRAH designation, subject to the satisfaction of ERCOT's membership and credit criteria.¹³ Once qualified, a market participant is obligated to meet all relevant market participation requirements/standards on an ongoing basis.

A. Annual Certification

In July 2012, the ERCOT Board of Directors approved Protocol revisions that require each market participant to annually certify to certain participant eligibility requirements. Specifically, each market participant must provide an annual certificate signed by an officer of the company attesting that the market participant:

- Has appropriate expertise in markets.
- Has appropriate operational capabilities to respond to ERCOT directions.

⁶ ERCOT Protocol Sections 16.2.1 and 16.8.1.

⁷ ERCOT Protocol Sections 16.8.1(1)(d) and 16.2.1(1)(d).

⁸ ERCOT Protocol Sections 16.8.1(1)(e) and 16.2.1(1)(e).

⁹ ERCOT Protocol Sections 16.8.1(1)(f) and 16.2.1(1)(f).

¹⁰ ERCOT Protocol Sections 16.8.1(1)(g) and 16.2.1(1)(g).

¹¹ ERCOT Protocol Sections 16.8.1(1)(h) and 16.2.1(1)(h).

¹² ERCOT Protocol Sections 16.8.1(1)(i) and 16.2.1(1)(i).

¹³ Entity generally means any natural person, partnership, municipal corporation, cooperative corporation, association, governmental subdivisions, or public or private organization.

- Meets the minimum capitalization requirements (discussed below).
- Maintains a risk management framework appropriate to the ERCOT markets in which it transacts or wishes to transact. ERCOT may review documentation supporting the market participant's risk management framework (see discussion of risk management verification below).

The annual certificate must be notarized, signed by an officer or executive with authority to bind the market participant, and submitted to ERCOT no later than 120 days after the close of the fiscal year of the market participant (or its guarantor). New market participants must provide such certification prior to their participation in the ERCOT markets.¹⁴

B. Minimum Capitalization Requirements

As noted above, the ERCOT Protocols, as revised, require all market participants to maintain a minimum capitalization, or in the alternative, post an independent secured amount. Specifically, to participate in the ERCOT markets, a market participant, or an acceptable guarantor, must maintain the following minimum capital:

- For a market participant seeking authorization to participate or participating in all ERCOT markets:
 - (A) \$10 million in total assets; or
 - (B) \$1 million in:
 - (1) Unencumbered assets for unrated Electric Cooperative ("EC") and Municipal systems; or
 - (2) Tangible net worth for all other entities.
- For a market participant seeking authorization to participate or participating in all ERCOT markets except for the CRR market:
 - (A) \$5 million in total assets; or
 - (B) \$500,000 in:
 - (1) Unencumbered assets for unrated EC and Municipal systems; or
 - (2) Tangible net worth for all other Entities, each as defined in the ERCOT Creditworthiness Standards.

¹⁴ ERCOT Protocol Section 16.16.2.

To meet the minimum capitalization requirement, a market participant must provide ERCOT with audited financial statements or those of its guarantor, or provide a guarantee in an amount equal to the minimum capitalization requirement. If a market participant cannot meet the minimum capitalization requirements, it can still participate in the ERCOT markets by posting an independent secured amount of \$500,000 for participation in all ERCOT markets and \$200,000 if participating in all ERCOT markets except the CRR market.

C. Verification of Risk Management Policies and Procedures

To verify that ERCOT market participants are eligible to participate in its markets, ERCOT will periodically review the risk management frameworks of selected market participants to verify that it includes the following key elements:

- The risk management framework is documented in a risk policy addressing market and credit risks that has been approved by the market participant's risk management function which includes appropriate corporate persons or bodies that are independent of the market participants trading functions, such as a risk management committee, a designated risk officer, the board or board committee, or, if applicable, a board or committee of the market participant's parent company.
- The market participant maintains an organizational structure with clearly defined roles and responsibilities that clearly segregate trading and risk control functions.
- There is clarity of authority specifying the transactions into which traders are allowed to enter.
- The market participant ensures that traders have adequate training and/or experience relative to their delegations of authority in systems and the markets in which they transact.
- As appropriate, a market participant has risk limits in place to control risk exposures.
- The market participant has reporting in place to ensure risks are adequately communicated throughout the organization.
- The market participant has processes in place for independent confirmation of executed transactions.¹⁵
- The market participant performs a periodic valuation or mark-to-market of risk positions, as appropriate.

¹⁵ ERCOT Protocol Section 16.16.3.

ERCOT performs risk management verification for market participants at its sole discretion and at least annually for any market participant (or its guarantor) if the market participant is: (1) ineligible for unsecured credit; and (2) has had exposure in CRR obligations during the year preceding the date of the annual certificate.

Upon receipt of notice that it has been selected for verification, the selected market participant must provide to ERCOT, within 30 days of the notice, documentation sufficient to show implementation of its risk management framework. In addition, the market participant must provide a written explanation of how its risk management framework conforms to the risk management standards summarized above. If necessary, ERCOT also can conduct interviews with appropriate personnel of the market participants, request responses to written inquiries, and conduct on-site observation of the market participant's credit and risk management processes and procedures.

Once ERCOT completes the verification review, it will notify the market participant of any material deficiencies, which must be corrected within a specified remediation period not to exceed 90 days. If the market participant fails to correct such deficiencies, it is deemed to be in material breach of its Standard Form Market Participant Agreement. At this point, ERCOT may suspend the market participant's activities in the ERCOT markets. ERCOT may elect to forego verification, if a market participant: (1) evidences that its risk management framework has been deemed sufficient for transacting in another ISO/RTO market in the United States; or (2) certifies (in the annual certificate) that there has been no material change in its risk management capabilities since the risk management framework was last verified. ERCOT may not forego verification for any market participant more than once every 24 month period.

This verification process will act as yet another measure to ensure that only appropriate entities with sufficient risk management procedures and capabilities transact in the ERCOT markets.

III. Credit Requirements

In addition to the participant eligibility requirements, ERCOT imposes extensive credit requirements for transactions in its markets, as further summarized below. The Commission can rely on these credit requirements, which provide additional protection for the ERCOT markets, to find that all ERCOT market participants are appropriate persons. Pursuant to the Public Utility Regulatory Act ("PURA") and the PUCT substantive rules, ERCOT must establish credit and security rules to ensure that potential financial risks associated with participation in its markets are mitigated pursuant to appropriate credit rules. As part of its credit process, ERCOT:

- Establishes unsecured credit for market participants within the boundaries defined in its Creditworthiness Standards. Unsecured credit is subject to a \$50 million

limit, applied at the corporate family level, and is granted solely within ERCOT's discretion.¹⁶

- Monitors daily for changes in creditworthiness of market participants, guarantors and banks, and takes action as needed.¹⁷
- Only accepts a limited number of forms of collateral, including third party guarantees, unconditional, irrevocable letters of credit ("LCs"), surety bonds with ERCOT as the beneficiary, or cash.¹⁸
- Utilizes standard forms to ensure strong and consistent terms and conditions are applied.
- Requires that any LCs must be: (1) issued by a bank with a minimum rating of A- with Fitch or S&P or A3 with Moody's; (2) issued on the Standard Form document approved by the ERCOT Board of Directors; and (3) accepted subject to the review and approval of ERCOT. ERCOT may, in its sole discretion, reject the LC if the issuer is unacceptable to ERCOT or if the conditions under which ERCOT may draw against the LC are unacceptable to ERCOT.¹⁹ ERCOT periodically reviews the concentration of letters of credit issued by a particular issuer to: (1) understand what, if any, concentration issues may exist in its markets; (2) educate market participants about concentration risk and determine what further actions, if any, are necessary; and (3) if a bank is determined to be at risk, ERCOT may reject its LC in accordance with section 16.11.3 of the Protocols.
- Ensures that the combined settlement and payment process occurs promptly. Invoice settlement for the Day Ahead Market ("DAM") activity, including settlement of most CRRs, occurs within 14 days.²⁰ DAM invoices are posted two business days after the relevant operating day, and payments to ERCOT are due within two bank business days after the DAM invoices are posted.²¹ Payments from ERCOT are made on the third day after the DAM invoices are posted. Real Time Market ("RTM") activity settlement occurs within 14 days for greater than 98% of operating days and no later than day 15 for the remaining operating

¹⁶ ERCOT Protocol Section 16.11.2 and ERCOT Creditworthiness Standards.

¹⁷ ERCOT Protocol Section 16.11.5.

¹⁸ ERCOT Protocol Section 16.11.3.

¹⁹ ERCOT Protocol Section 16.11.3. .

²⁰ ERCOT Protocol Sections 9.2.4, 9.3 and 9.4.1.

²¹ ERCOT Protocol, Sections 9.3 and 9.7 as modified by Nodal Protocol Revision Request ("NPRR") 347.

days.²² In addition, all outstanding receivables are included in ERCOT's credit exposure calculation and are collateralized as required by ERCOT Protocols.²³

- Updates credit exposure for all markets at least once each day, including holidays and weekends, to ensure exposure is adequately covered, including estimated mark-to-market values for CRRs.²⁴ Forward exposure for CRRs is determined for all CRRs held based on auction clearing price and recent historical pricing.²⁵ A Protocol change has been approved that will eliminate netting of current exposure from DAM and RT activity with CRR forward mark-to-market positions. Implementation of this change is expected in 2012.²⁶
- Requires market participants to post collateral for 100% of calculated market exposure, net of unsecured credit, which, as described below, will not be available for CRR positions under the revised credit rules.²⁷
- Operates all ERCOT market activity under one credit limit, utilizing both collateral and unsecured credit.²⁸ Under approved revisions to ERCOT protocols, CRR Auction and CRR forward mark-to-market values will be fully collateralized rather than subject to unsecured credit. Implementation of these revision is expected in 2012.
- Restricts a market participant's participation in the DAM and future CRR Auctions to the lesser of their Available Credit Limit (ACL) or their self-imposed limit. The ACL is equal to an entity's unsecured credit (if any) plus collateral less its Total Potential Exposure (TPE). Market Participants are prohibited from participating in the DAM and future CRR Auctions if their TPE exceeds their credit limit. Unsecured credit is not be available for CRR positions.²⁹
- Requires market participants to provide ERCOT with all necessary information (*e.g.*, audited and unaudited financials) for themselves or their guarantors as well as notification of any status change that may affect unsecured credit rights, if applicable to ensure ERCOT has the information it needs to evaluate credit risk in the market.³⁰

²² ERCOT Protocol Sections 9.5.4, 9.6 and 9.7.1.

²³ ERCOT Protocol Section 16.11.4.3.

²⁴ ERCOT Protocol Section 16.11.4.1.

²⁵ ERCOT Protocol Section 16.11.4.5

²⁶ ERCOT Protocol Section 16.11.4.1.

²⁷ ERCOT Protocol Section 16.11.1.

²⁸ ERCOT Protocol Sections 16.11.4.1 and 16.11.4.6.

²⁹ ERCOT Protocol Sections 16.11.4.6, 16.11.4.6.1, and 16.11.4.6.2.

³⁰ ERCOT Protocol Section 16.11.5 (1).

- If an entity's TPE equals or exceeds its credit limit (*e.g.*, its financial security plus its unsecured credit, if applicable), ERCOT requires the entity to post additional collateral within two bank business days.³¹ Until corrected: (1) ERCOT can withhold any other payments due to that entity;³² and (2) ERCOT systems prohibit participation in the DAM or upcoming CRR Auctions that would create potential liability since the entity's Available Credit Limit is zero. A market participant is in payment breach if it does not pay an invoice when due or post collateral within two bank business days.³³
- Requires a market participant to cure a payment breach within two bank business days. The breaching entity may be restricted from any participation in DAM activity and future CRR Auctions until the payment breach is cured. The consequences of a default are that the participant's rights to participate in all ERCOT markets may be terminated.³⁴

If a market participant violates its credit obligations, ERCOT may terminate, expel, suspend, or sanction the market participant. In addition, Sections 16.11.6.1 and 16.11.6.2 of the ERCOT Protocols specifically provide for the following remedies:

- No Payments by ERCOT to the defaulting participant.
- ERCOT may draw on, hold, or distribute funds of the participant.
- Aggregate amounts owed by breaching participant become immediately due.
- Repossess and resell CRRs held by the participant (sale proceeds offset debt).
- Honor cleared CRRs but remove them from the participant's account and use proceeds to offset debt.
- Revoke the participant's rights and terminate its outstanding agreements (the market participant remains liable for all debt and consequences for termination/revocation).

IV. Market Monitoring and PUCT Oversight

The Commission should find that all market participants eligible to participate in the ERCOT markets are "appropriate persons" because transactions in the ERCOT markets are subject to pervasive market monitoring and comprehensive PUCT oversight.

³¹ ERCOT Protocol Section 16.11.5 (3).

³² ERCOT Protocol Section 16.11.5 (3).

³³ ERCOT Protocol Section 16.11.6.

³⁴ ERCOT Protocol Section 16.11.6.

A. Market Monitoring

PURA and the PUCT Substantive Rules specifically address market power, manipulation, and abuse issues, and establish an Independent Market Monitor (“IMM”) for the ERCOT region. The IMM’s purpose is to monitor market behavior and report any market compliance issues to the PUCT.³⁵ The IMM also monitors and recommends changes in the ERCOT market rules.³⁶ The IMM reports to the PUCT and its duties are delineated in the PUCT Substantive Rules.³⁷ ERCOT supports the IMM and the PUCT in their market oversight and monitoring roles.³⁸ The IMM is required to be qualified and staffed to perform its functions, and the PUCT is charged with ensuring the IMM has adequate resources to perform its functions, including being adequately funded.³⁹ The IMM can communicate with the PUCT on any matter, and is required to report any market issues to the PUCT.⁴⁰ ERCOT is required to cooperate with the IMM in this role, including, but not limited to, providing information and data to support the IMM activities and functions.⁴¹ This is in addition to monitoring its own rules as the ISO responsible for administration of the ERCOT market.⁴² Market participants are similarly required to provide information to the IMM.⁴³ The IMM role facilitates market rule enforcement in the ERCOT region by providing a focused market monitoring function that supports the PUCT enforcement role in the ERCOT region.⁴⁴

B. PUCT Oversight

As Petitioners discussed in the Exemption Request and the attachments thereto, and as recognized by the Commission in the Proposed Order, ERCOT is subject to the PUCT’s long-standing and comprehensive regulatory regime. In addition to the roles of the IMM and ERCOT, the PUCT has an enforcement division charged with overseeing, monitoring and enforcing rules in the ERCOT market. ERCOT provides support to the PUCT in this role, and is required to provide information to the PUCT as necessary, including supporting its investigatory functions. The PUCT can take any action appropriate for contravention of market rules. The IMM also

³⁵ PURA §§ 39.157 and 39.1515 and P.U.C. SUBST. R. 25.503(g).

³⁶ PURA § 39.1515(a) and P.U.C. SUBST. R. 25.365(c) and (d).

³⁷ PURA § 39.1515 and P.U.C. SUBST. R. 25.365.

³⁸ PURA § 39.1515(b), P.U.C. SUBST. R. 25.365(e) and (m) and ERCOT Protocol Section 17.

³⁹ PURA § 39.1515(d) and P.U.C. SUBST. R. 25.365(g) and (h).

⁴⁰ P.U.C. SUBST. R. 25.365(l)(1) and (2).

⁴¹ PURA § 39.1515(b) and P.U.C. SUBST. R. 25.365(e)(3) and 25.365(m).

⁴² P.U.C. SUBST. R. 25.503(j). This applies to operations but market obligations and performance are directly related to operations and ERCOT monitors market activity pursuant to this specific obligation and its general obligation as the market administrator charged with administering efficient markets.

⁴³ P.U.C. SUBST. R. 25.365(e)(3).

⁴⁴ Specific authority granted to ERCOT in the ERCOT Protocols also allows ERCOT to limit or suspend market participation (*e.g.*, authority in Sections 8 and 16 of the ERCOT Protocols for violations of performance and credit obligations, respectively).

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Assistant Secretary
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reports to the PUCT regarding market digressions and/or violations. Collectively, these authorities and the entities charged with executing the duties thereunder provide a comprehensive oversight and enforcement framework that facilitates market participant compliance with all relevant rules.

V. Conclusion

ERCOT appreciates the Commission's consideration of its supplemental comments. For the foregoing reasons, ERCOT respectfully requests that the Commission find that all market participants that are eligible to participate in the ERCOT markets and that meet ERCOT's credit and market requirements, are appropriate persons that can benefit from the Commission's final order granting the Petitioners' Exemption Request.

Respectfully submitted,



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