

December 11, 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 and October 9, 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

I. Introduction

In February 2012, several ISOs, including ERCOT, and one RTO (collectively, “Petitioners”) filed a joint request (“Joint Request”) with the Commission for an exemption from all but the anti-manipulation and anti-fraud provisions of the Commodity Exchange Act (“CEA”) and CFTC regulations thereunder. On August, 28, 2012, the Commission issued the Proposed Exemption Order addressing the Joint Request. On September 27, 2012, the Petitioners filed comments on the Proposed Exemption Order (“Joint Comments”), and on October 9, 2012, ERCOT filed individual supplemental comments to address certain ERCOT specific issues.

The Proposed Exemption Order only applies to market participants that: (1) fall within the categories of “appropriate persons” in Section 4(c)(3) of the CEA; or (2) are eligible contract participants (“ECPs”) as defined in Section 1a(18) of the CEA and Commission regulation

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 Exemption Order”).

1.3(m) (collectively “Appropriate Persons”).² The Joint Comments addressed this issue, noting that the Commission’s proposed Appropriate Persons would exclude market participants that are currently eligible to participate in the Petitioners’ markets under their respective rules. In the Joint Comments, the Petitioners asked the Commission to revise the Proposed Exemption Order to cover all currently eligible participants in the Petitioners’ markets.

With respect to ERCOT, the Joint Comments stated the proposed Appropriate Persons would exclude a “non-trivial” number of market participants.³ At the request of CFTC Staff, ERCOT files these supplemental comments to provide additional detail on the impact of the proposed scope of Appropriate Persons on the ERCOT markets. ERCOT requests that the Commission consider the following information in determining the scope of persons who will be eligible for the exemption in the final order.

II. Summary of ERCOT’s Supplemental Comments

Assuming that the Commission expands Appropriate Persons categorically to include generation and load serving entities (“LSEs”), it does not appear that the Commission’s proposed Appropriate Persons limitation would have a material effect on participation and liquidity. However, this regulatory limitation also would provide little additional market protection or risk mitigation benefits given ERCOT’s extensive market participant eligibility requirements, credit requirements, and risk management measures. In addition, imposing such a limitation is contrary to Texas law, regulation, and policy related to restructuring of the Texas electricity industry and the general guiding principles of fair, open, and non-discriminatory access to the ERCOT markets. Therefore, ERCOT requests that the Commission expand the proposed Appropriate Persons to include all market participants eligible to participate in the ERCOT markets.

III. Impact of the Proposed Appropriate Persons Limitation on the ERCOT Markets

A. Gross Number of Market Participants That Are Not Appropriate Persons Under the Proposed Exemption Order

The current number of eligible counterparties in the ERCOT markets is approximately 224. The number of ERCOT market participants that would not be Appropriate Persons under the Proposed Exemption Order is 35, leaving a total of 189 ERCOT market participants that are eligible to rely on the Commission’s Proposed Exemption Order. This would result in a loss of approximately 16% of eligible counterparties. Assuming that all generation and LSEs are Appropriate Persons, the number of affected entities would be 18, which primarily includes financial traders.

² Proposed Exemption Order at 52142; 7 U.S.C. 6(c)(3); 17 C.F.R. 1.3(m).

³ Joint Comments at note 8.

It should also be noted that out of the 35 counterparties that would not be Appropriate Persons, approximately 25 would be excluded from participation in the ERCOT Day-Ahead & Real-Time markets, and all but one would be excluded from the participation in the Congestion Revenue Rights (“CRR”) markets pursuant to revisions to the ERCOT market rules that are comparable to the requirements of FERC Order No. 741.⁴ Consequently, after implementation of ERCOT’s Revised Market Participant Eligibility Requirements, ERCOT estimates that approximately 10 entities would be impacted by the proposed scope of Appropriate Persons in the Proposed Exemption Order.

B. Types of Market Participants That Would be Excluded From the ERCOT Markets

Counterparties can have demand and/or supply positions in the ERCOT markets. Accordingly, when assessing the impact of the proposed Appropriate Persons limitation on the ERCOT markets, affected entities are not categorized as generators, LSEs or financial traders. Rather, they are viewed in terms of their net market positions and are defined in terms of net load, net generation, or no load-no generation. While entities are categorized based upon net positions, it is reasonable to assume that in many cases net load entities are LSEs (which are either competitive retail suppliers or municipal utilities or electric cooperatives), net generation entities are generators, and no load-no generation entities are financial traders.

The composition of the 35 market participants that would be ineligible to participate in the ERCOT as a result of the proposed Appropriate Persons limitation is as follows:

- Sixteen Net Load Counterparties;⁵
- One Net Generation Counterparty;⁶
- Eighteen No Load-No Generation Counterparties.

Presently, there are a total of 28 net generation counterparties in ERCOT. Accordingly, elimination of the single net generation counterparty represents an approximate four percent reduction in that type of market participant. With respect to net load, there are a total of 63 eligible counterparties. The loss of 16 would result in an approximate loss of 25% of that type of

⁴ As the Commission is aware, ERCOT has made several revisions to its market rules, including certain market participant eligibility requirements, that are comparable to the credit reform requirements of Order No. 741 of the Federal Energy Regulatory Commission (“ERCOT’s Revised Market Participant Eligibility Requirements”). The 25 entities impacted by ERCOT’s Revised Market Participant Eligibility Requirements include nine net load, one net generation and 15 no load-no generation counterparties. Throughout this comment, any references to market participants that would be excluded from participation in the ERCOT markets as a result of implementing ERCOT’s Revised Market Participant Eligibility Requirements assumes that such excluded market participants have not undertaken any measures to comply with ERCOT’s Revised Market Participant Eligibility Requirements.

⁵ If Appropriate Persons include LSEs, these entities would not be affected.

⁶ If Appropriate Persons include generators, these entities would not be affected.

market participant. If Appropriate Persons include generators and LSEs, there would be no impact to these entities. Finally, there are presently 133 no load-no generation counterparties in ERCOT. The loss of the 18 entities that would not be eligible under the proposed Appropriate Persons categories would result in an approximate 14% reduction in that type of market participant.

However, ERCOT's Revised Market Participant Eligibility Requirements, which are expected to be fully implemented by January 2013, will result in 25 of the 35 entities affected by the proposed Appropriate Persons limitation being ineligible to participate in the ERCOT markets. This result is independent of the effect of the Appropriate Person limitation in the Commission's Proposed Exemption Order. The 25 counterparties impacted by ERCOT's Revised Market Participant Eligibility Requirements include nine net load, one net generation, and 15 no load-no generation counterparties. Thus, after implementation of ERCOT's Revised Market Participant Eligibility Requirements, the proposed Appropriate Persons limitation would impact 10 counterparties, which would include seven net load and three no load-no generation. If the proposed Appropriate Persons include LSEs, then three no load-no generation counterparties (*i.e.*, financial traders) would be impacted by the proposed Appropriate Persons limitation.

C. Expected Impact on Wholesale Market Liquidity

The impact on wholesale market liquidity will depend on the metric used to define liquidity. If the determination is based on the reduction in the number of market participants, it is reasonable to conclude that a four percent reduction in net generation counterparties does not represent a significant impact. Furthermore, there would be no impact if the Commission determines that all generators are Appropriate Persons. Even assuming that all generators are not Appropriate Persons, implementation of ERCOT's Revised Market Participant Eligibility Requirements would render the single net generation entity affected by the proposed Appropriate Person limitation ineligible to participate in the ERCOT market. Accordingly, the proposed Appropriate Persons limitation would have no effect on net generation counterparties, because the sole impacted entity would be precluded from participating in the ERCOT markets by the pending revisions.

With respect to net load, a 25% reduction in the number of counterparties could have a meaningful impact.⁷ There would be no impact if the Commission determined that all LSEs are Appropriate Persons. Even assuming that LSEs are not covered, implementation of ERCOT's Revised Market Participant Eligibility Requirements, would make nine of the net load counterparties that would not be Appropriate Persons ineligible to participate in the ERCOT

⁷ It should be noted that this metric does not necessarily equate to proportional impacts to market activity or transactions. The impacted entities could represent a high percentage or low percentage of market transactions. However, any reduction in eligible counterparties reduces the potential to increase market liquidity. Although this is a qualitative consideration, it has merit. Accordingly, the value of this metric must be viewed in that light of these considerations.

markets. Accordingly, the Appropriate Persons limitation would affect seven net load counterparties, which reduces the percent reduction in eligible counterparties from approximately 25% to 11%.

Finally, the proposed Appropriate Persons limitation will impact 18 no load-no generation counterparties. This reflects an approximate 14% reduction in that type of counterparty. However, as discussed above, implementation of ERCOT's Revised Market Participant Eligibility Requirements will independently eliminate 15 of the 18 no load-no generation counterparties that would be affected by the proposed Appropriate Persons limitation, decreasing the number of no load-no generation counterparties that would not be Appropriate Persons to three. This equates to an approximate two percent reduction in eligible no load/no generation counterparties. This two percent reduction is arguably insignificant when viewed solely from the impact to the number of eligible market participants.

Another way to look at liquidity impacts is to look at the market exposure presented by the impacted entities. If the exposure is high, it can be assumed that the entities represent a non-trivial degree of market activity. Conversely, if it is low, it can be assumed that the entities represent a small volume of market activity. The 35 entities that would not qualify as Appropriate Persons represent approximately 0.3% of the total market exposure, as defined in the ERCOT Protocols. Assuming that low exposure aligns with insignificant market activity, it can be concluded that the loss of the 35 affected entities would not significantly impact market liquidity.⁸ This number is further reduced if the Commission includes all LSEs and generators as Appropriate Persons and by the independent impact of the pending ERCOT Revised Market Participant Eligibility Requirements.

Finally, the actual number of market transactions and positions associated with the affected counterparties could be used to assess liquidity impacts. To estimate the liquidity impact of the loss of the affected counterparties, ERCOT calculated the total MW bids into the November 2012 monthly CRR auction by counterparty.⁹ Using this approach, counterparties that would potentially not qualify as Appropriate Persons accounted for 74,449.5 out of 2,873,187 MW bid, or 2.6%. All of the MW bids that would be excluded were associated with financial traders. After implementation of ERCOT's Revised Market Participant Eligibility Requirements, the excluded bids would account for 2.5% of total market bids. Again, the liquidity impact would result solely from financial traders. Therefore, the Appropriate Persons limitation would appear to have an immaterial incremental liquidity impact above that associated with the effects of ERCOT's Revised Market Participant Eligibility Requirements.

⁸ This metric does not necessarily reflect the degree of market activity represented by the affected entities, because market exposure reflects netting of positions. Thus, an entity could engage in significant supply and demand transactions, and the resulting offsetting credit/charge positions could net against each other resulting in limited exposure position despite a high degree of market activity.

⁹ This is only one potential way of defining liquidity. Alternatives might include net physical or financial positions, MWh equivalent bids, or notional bid values.

Considering all of the above metrics, it is arguable that the loss of the affected entities would not result in a significant detrimental effect to liquidity. However, liquidity should not be the only consideration in assessing the effect of the proposed Appropriate Persons limitation to the ISO/RTO markets. If the risk mitigation benefit is trivial, then imposition of the standard arguably is not warranted despite the fact that it would not affect liquidity to any significant degree.

D. Expected Impact on the Competitive Retail Market

Retail service in ERCOT is provided either competitively or by municipal utilities and electric cooperatives in the service territories of those entities that have not opted into competition. The proposed Appropriate Persons limitation would not affect any municipal utilities or electric cooperatives.¹⁰ Therefore, the following discussion focuses solely on the competitive market.

The impact on the competitive retail market can be viewed in two ways: first, a negative impact on market liquidity may negatively impact efficient wholesale pricing that would flow through to retail rates; and, second, the Appropriate Persons limitation potentially may reduce the number of competitive choices available to retail customers.

As discussed above, it does not appear that the proposed Appropriate Person limitation would have a significant impact on market liquidity in ERCOT. The second potential impact on the retail market would be a reduction in the number of competitive choices available to retail customers. If the proposed Appropriate Persons include all LSEs, then there will be no impact on the competitive retail market in this respect. However, if it does not categorically include all LSEs, and if those LSEs do not otherwise qualify as Appropriate Persons, they will not benefit from the Proposed Exemption Order and may be precluded from wholesale market participation. This will result in a decreased number of available competitive options in the retail market from 63 to 49 suppliers.

E. Expected Impact on System Reliability

The primary impact on reliability would be related to the loss of supply capacity if generators were prohibited from wholesale market participation. This is not an issue if the proposed Appropriate Persons categories include all generators. If not, only one net generation counterparty would be impacted by the proposed limitation. However, if that entity is not able to meet ERCOT's Revised Market Participant Eligibility Requirements, it will be ineligible to participate in the ERCOT markets independent of the Commission's Proposed Exemption Order.

¹⁰ See Proposed Exemption Order at 52145 ("The Commission notes here that CEA 4(c)(3)(H) includes as eligible appropriate persons 'Any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing.' This appropriate persons category would cover the municipalities and other government owned market participants.").

F. Total Market Exposure Represented by the Counterparties That Are Not Appropriate Persons

The market exposure of the entities that would not be Appropriate Persons under the Proposed Exemption Order is 0.3% of the total market exposure. This number decreases if all LSEs and generators are categorically included as Appropriate Persons. Furthermore, ERCOT's Revised Market Participant Eligibility Requirements, would potentially reduce that number from 25 to 35 *independent* of the Proposed Exemption Order's Appropriate Persons limitation.

The 25 entities that will be independently excluded by the application of ERCOT's Revised Market Participant Eligibility Requirements represent 0.23% of total market exposure. Netting that against the 0.3% market exposure represented by the 35 entities that may not be Appropriate Persons, would mean that the potential risk mitigation benefit of the proposed Appropriate Person limitation would only be 0.07% of total market exposure. Accordingly (even under the 0.3% conservative number), the benefit of the Appropriate Person limitation in ERCOT is not apparent given the immaterial marginal risk it would address.

IV. Existing Rules That Mitigate the Risk Presented by Market Participants That Would Not Be Appropriate Persons

The existing ERCOT eligibility and credit rules require full collateralization of all market exposure and timely settlement and payment. ERCOT has broad authority to address any failure by counterparties to meet their eligibility and credit obligations. Additional protections will be added pursuant to ERCOT's Revised Market Participant Eligibility Requirements. All counterparties are obligated to comply with all of these rules.¹¹ In addition, retail providers in ERCOT are also subject to stringent PUCT eligibility rules that effectively mitigate risk by ensuring they are responsible, qualified entities.

These requirements, existing and pending, are described in detail in the ERCOT section of the Joint Request and are incorporated by reference herein. The limited market exposures represented by the entities that would not be Appropriate Persons are subject to these existing protections, and will be subject to the incremental protections imposed by the relevant rule revisions.

¹¹ P.U.C. SUBST. R. 39.151 (j) ("A retail electric provider, municipally owned utility, electric cooperative, power marketer, transmission and distribution utility, or power generation company shall observe all scheduling, operating, planning, reliability, and settlement policies, rules, guidelines, and procedures established by the independent system operator in ERCOT. Failure to comply with this subsection may result in the revocation, suspension, or amendment of a certificate as provided by Section 39.356 or in the imposition of an administrative penalty as provided by Section 39.357.").

V. The Proposed Appropriate Persons Limitation is Inconsistent with the Design and Purposes of the ERCOT Market

The basic foundation of electric restructuring in ERCOT is that competitive forces should dictate pricing. To foster competition, the market rules should be non-discriminatory, with only necessary regulatory intervention. Restrictions that facilitate the competitive goals are appropriate, but they must be justified from a cost-benefit perspective. The authorities discussed below do not preclude appropriate regulation. Rather, they establish a framework that facilitates competition, but also allows for appropriate regulation to achieve and manage that outcome. Consistent with the principle of minimizing regulatory intervention and its impact on competitive forces, any regulatory overlay should be justified and narrowly tailored to address the issue. The regulation should address a real issue that has the potential to undermine the benefits of market competition, and it should address the issue in the least intrusive way possible. It does not appear that application of the proposed Appropriate Persons limitation addresses a real concern, and, therefore, contravenes the guiding principles for the ERCOT markets by unnecessarily excluding market participants.

A. Legislative Policy to Facilitate Electric Restructuring

Chapter 39 of the Public Utility Regulatory Act (“PURA”) addresses restructuring of the electric industry in Texas. Core to the restructuring initiative is the concept of electric supply competition.¹² To facilitate the goal of efficient competition, PURA supports minimal regulatory intrusion. Paragraphs (c) and (d) of Sec. 39.001 state:

(c) Regulatory authorities . . . may not make rules or issue orders regulating competitive electric services, prices, or competitors or restricting or conditioning competition except as authorized in this title and may not discriminate against any participant or type of participant during the transition to a competitive market and in the competitive market.

(d) Regulatory authorities. . . shall authorize or order competitive rather than regulatory methods to achieve the goals of this chapter to the greatest extent feasible and shall adopt rules and issue orders that are both practical and limited so as to impose the least impact on competition.

While these overarching principles focus on retail competition, to the extent the Commission’s Proposed Order compromises the ability of some retail providers to participate directly in the wholesale market, and that, in turn, compromises the business models of those entities, either independently or relative to their competitors, then the proposed Appropriate Persons limitation appears to be inconsistent with the competitive principles underlying the transition to, and administration of, electric competition in Texas as established by the Texas legislature.

¹² Public Utility Regulatory Act, TEX. UTIL. CODE ANN. § 39.001(a) (Vernon 1998 & Supp. 2005) (PURA).

B. Relevant PURA Principles Governing ERCOT Market Design

One of the core functions of ERCOT is to ensure that buyers and sellers of electricity in the ERCOT region have access to the electric system on non-discriminatory terms.¹³ Absent adequate justification, excluding market participants through implementation of the Commission's proposed Appropriate Persons limitation may be inconsistent with this general statutory charge. This role, as well as all other ERCOT functions, is further guided by the regulations and rules of the Public Utility Commission of Texas ("PUC") and the ERCOT rules, which primarily include the ERCOT Protocols and Operating Guides.¹⁴

C. PUCT Rules

1. Governing Principles

Chapter 25 of the PUCT Rules governs the regulation of the ERCOT markets consistent with the overarching principles in PURA. Section 25.1, which generally establishes the role of the PUCT, states that the PUCT shall regulate while facilitating competition, operation of the free market, and customer choice.¹⁵ The ERCOT rules governing transmission access support the overarching principle that establishes efficient and effective competition as the core foundation of electric restructuring in Texas.

2. Transmission Open Access

In order to support the competitive benefits of the restructured electric markets in the ERCOT region, the PUCT rules impose open access obligations on all transmission providers.¹⁶ Paragraph (a), which establishes the purpose of open access, clearly describes the relationship to promoting effective and efficient competition by explicitly stating that the intent is to facilitate competition and enhance economic efficiency in the production and consumption of electricity. In addition, open access is intended to support system reliability as well. As noted, the establishment of an ISO as the central operational and markets administrator facilitates the benefits of restructuring and open access.

3. ERCOT Functions

Section 25.361 of the PUCT Rules establishes the functions of ERCOT. Consistent with supporting competition via open access and otherwise, ERCOT's core functions include providing non-discriminatory and open access to the transmission system for all buyers and sellers of electricity.¹⁷ In addition, ERCOT is generally charged with operating the system and

¹³ See PURA §39.151 (a) (1).

¹⁴ See PURA §39.151 (h).

¹⁵ See P.U.C. SUBST. R. 25.1(a).

¹⁶ See P.U.C. SUBST. R. 25.191.

¹⁷ See P.U.C. SUBST. R. 25.361(b).

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administering the markets consistent with relevant PUCT rules, orders, and regulations. Section 25.501 further defines ERCOT's market role in terms of guiding principles. This section states that ERCOT shall perform these functions in consideration of microeconomic principles and that ERCOT shall promote economic efficiency in the production and consumption of electricity and support wholesale and retail competition as well as system reliability, while respecting the physical limits of the system, which supports economic efficiency by ensuring positions reflect, and are directly related to and limited by, the capacity of the system. The direction and mandates established by the PUCT Rules are further implemented pursuant to the ERCOT rules (*e.g.*, Protocols and Operating Guides).

VI. 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: (1) are eligible to participate in the ERCOT markets; and (2) meet ERCOT's credit and market requirements, are Appropriate Persons that can benefit from the Commission's final order granting the Petitioners' Joint Request.

Respectfully submitted,



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