

January 9, 2013

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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; Supplemental Comments

Dear Ms. Warfield:

On behalf of our clients, Petitioners California Independent System Operator Corporation (“CAISO”) and ISO New England Inc. (“ISO-NE”), we respectfully submit these supplemental comments to the Commodity Futures Trading Commission (“Commission”), in response to the Proposed Order and Request for Comment released by the Commission on August 28, 2012.

I. Introduction

The Proposed Order is in response to a consolidated Petition filed on February 7, 2012, and updated on June 11, 2012 by CAISO, ISO-NE, and several other Independent System Operators (“ISOs”) and Regional Transmission Organizations (“RTOs”).¹ Pursuant to section 4(c)(6) of the Commodity Exchange Act, 7 U.S.C. § 1 et seq. (“CEA” or “Act”), the Petition requested that the Commission exempt from the provisions of the Act certain Transactions on Petitioners’ markets that are conducted pursuant to a tariff or protocol approved by the Federal Energy Regulatory Commission (“FERC”) or the Public Utility Commission of Texas (“PUCT”).² Sections 4(c)(1) and (2) of the Act specify that such an exemption may be granted if the Commission finds that the exemption would be “consistent with the public interest and the purposes of [the Act],” that the exempted transactions would solely involve “appropriate

¹ CAISO and ISO-NE were joined by Electric Reliability Council of Texas, Inc., Midwest Independent Transmission System Operator, Inc., New York Independent System Operator, Inc., and PJM Interconnection, L.L.C.

² Because CAISO and ISO-NE are regulated only by FERC, this letter will omit any further reference to PUCT.

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persons,” and that the transactions would not have a “material adverse effect” on the Commission’s regulatory jurisdiction.

The Commission credited much of Petitioners’ representations and has proposed to grant a broad exemption with respect to the Transactions. The Commission “determine[d] that, due to the FERC ... regulatory scheme and the RTO/ISO ... market structure already applicable to the Transactions, the linkage between the Transactions and those regulatory schemes, and the unique nature of the market participants [on Petitioners’ markets], CEA section 4(a) should not apply to the Transactions.” 77 Fed. Reg. 52138, 52145 (Aug. 28, 2012). However, the Commission also proposed placing certain conditions on the exemption. Among other things, it indicated that it will decline to exempt Transactions that are not between “appropriate persons” as defined in section 4(c)(3)(A)-(J) or “eligible contract participants” as defined in section 1(a)(12). *Id.* at 52145.

Under section 4(c)(3)(A)-(J) of the Act, an “appropriate person” is defined as any of several enumerated institutions, and, under section 4(c)(3)(K) of the Act, as such “other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections.” The Petitioners noted that not all participants authorized under their Tariffs as approved by FERC to participate in their markets fall within the enumerated categories of “appropriate person” under section 4(c)(3)(A)-(J) of the Act. Petitioners therefore requested that the Commission exercise its discretion under section 4(c)(3)(K) of the Act and determine that all participants authorized under their Tariffs to participate on their markets are “appropriate persons” based upon “their other qualifications, including their traditional participation in the wholesale markets for electricity and the minimal degree of risk that they pose to the ISO/RTO markets.” Nevertheless, the Commission declined to do so, requesting comments on its determination. Petitioners responded to the Commission’s request for comment on its appropriate person determination in a consolidated letter dated September 27, 2012.

In the September 27 comment letter, Petitioners noted that:

the Commission should conclude that all persons who are authorized to transact in FERC or PUCT-regulated ISOs/RTOs are Appropriate Persons because they must satisfy the financial requirements of the ISOs/RTOs and because of the applicability of ‘appropriate regulatory protections,’ namely FERC and PUCT oversight of the organized electricity markets and their participants. The Commission has discretion to determine that such persons qualify as Appropriate Persons ‘in light of their financial or other qualifications, or the applicability of appropriate regulatory protections.’³

³ Letter to Sauntia Warfield from Consolidated Petitioners, dated September 27, 2012, at p.2.

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Subsequently, Commission staff requested that the Petitioners supplement their comment letter. Petitioners CAISO and ISO-NE respectfully request that the Commission consider the following supplemental information and analysis.

II. The Commission's Exclusion Of A Small, But Not Insignificant, Number Of Market Participants From Its Exemptive Order Will Have an Adverse Effect

A. Uncertainty Will Arise from the Commission's Order

As Petitioners have previously explained, it is essential that Petitioners' wholesale electricity markets—including the sale or offer of all the Transactions—be subject to uniform and consistent regulation. These integrated markets were developed by FERC for the purpose of establishing the efficient and cost-effective distribution of electricity, and they are subject to longstanding and comprehensive oversight by FERC. In this regard, FERC has considered and approved the admission criteria for market participants provided in the Petitioners' Tariffs. For this reason, it would be proper for the Commission to exercise its authority under section 4(c)(3)(K) to deem as "appropriate persons" any entities that participate in Petitioners' markets pursuant to the conditions set forth in those Tariffs, but which otherwise do not meet one of the definitions of "appropriate person" in section 4(c)(3)(A)-(J) of the Act. These entities (the "Additional Participants") benefit the markets by adding liquidity while at the same time presenting little or no systemic risk.

If the Commission, as it has proposed, declines to include all market participants authorized by CAISO's or ISO-NE's Tariffs within the Exemptive Order, the result will be regulatory uncertainty. It will not be possible for Petitioners to operate their markets efficiently with certain participants subject to regulation by both the Commission and FERC. The application of two regulatory schemes to some participants within a single market will result in the confusing application of competing and inconsistent regulation by both FERC and the Commission. This is precisely the problem that Congress empowered the Commission to avoid by its enactment of section 4(c)(6) of the Act and which can easily be remedied as described in the remainder of this filing.

B. Exclusion of the Additional Participants Will Affect the Markets

In the Proposed Order, the Commission recognized the unique nature of Petitioners' markets, and it relied on that finding to propose the exemption. As the Commission noted, Petitioners' markets are inextricably intertwined with the physical distribution of electricity. Over the years, FERC encouraged the creation of ISOs and RTOs to "improve both the reliability of the physical operations of electric transmission systems as well as the competitiveness of electricity markets," and also to "ensure that consumers are able to purchase electricity on a safe, reliable and affordable basis." 77 Fed. Reg. at 52141. In addition to charging ISOs and RTOs

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with administering the physical transmission grids for electricity, FERC also encouraged them to establish the wholesale electricity markets to help efficiently allocate the use of the grid and to optimize the wholesale pricing of electricity.⁴ These markets—which include the sale and offer of the Transactions—“are an essential means, designed by FERC ... as an integral part of their statutory responsibilities, to enable to delivery of affordable electricity.” *Id.* at 52142.

Petitioners’ wholesale electricity markets mainly cater to load-serving entities (LSEs), their suppliers and others whose primary business is the physical generation of electricity and most transactions on the markets thus involve the actual supply and demand of electricity. Some entities also engage in financial transactions to hedge the pricing risk associated with their delivery of electricity. A small number of entities that are not involved in the generation of electricity and that are not otherwise appropriate persons under section 4(c)(3)(A)-(J)—the Additional Participants—also engage in these financial transactions or are direct access customers and purchase electricity directly from the wholesale market. The Additional Participants do not change the nature of Petitioners’ markets. Nevertheless, they do provide additional liquidity to the market, and thus help ensure the efficient allocation of electricity or, in the case of ISO-NE are involved in the purchase of electricity from the wholesale market.

The Additional Participants principally engage in two aspects of Petitioners’ markets—virtual transactions and financial transmission rights (“FTRs”).⁵ However, in the case of ISO-NE, some Additional Participants are direct purchasers who purchase electricity from the ISO wholesale market. These markets were developed in response to FERC policy, and they are directly tied to the electricity distribution system. As explained below in the specific context of CAISO and ISO-NE, the Additional Participants play a role in virtual transactions, FTRs and in Energy Transactions.

Virtual transactions. As Petitioners previously explained, virtual transactions enable participants to buy or sell power in the day-ahead market, even if they do not control physical resources. These transactions enable convergence between the prices in the real-time and day-ahead markets because virtual bidding allows participants to arbitrage the difference between the two markets. This results in greater price predictability and more economically efficient wholesale electricity prices. FERC has expressly encouraged Petitioners to establish these virtual markets because “virtual bidding reduces the price differential between real-time and day-ahead prices, [and] it also reduces the financial risks associated with the inevitable real-time deviations from each customer’s day-ahead schedule.” California Indep. Sys. Operator Corp., 107 FERC ¶ 61274, 62271 (June 17, 2004).

⁴ See generally Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services By Public Utilities (Order No. 888), 61 Fed. Reg. 21540 (May. 10, 1996); Regional Transmission Organizations (Order No. 2000), 65 Fed. Reg. 810 (January 6, 2000).

⁵ The different Petitioners use various terminology for these two markets. But in order to remain consistent with the terminology used in the petition, this letter will use the terms “virtual transactions” and “FTRs.”

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Many virtual transactions are conducted by LSEs who want to hedge their market exposure in the real-time market. But some are also conducted by the Additional Participants. In the CAISO market, 70 participants are authorized to engage in virtual transactions. Of those, 13 may be Additional Participants. This is necessarily an estimate because certain market participants rely on collateral on hand with CAISO to meet the admission standard and thus CAISO is not able independently to verify each participant's appropriate person status on the basis of audited financials submitted to CAISO. In terms of total dollar volume, approximately 25-29% of the virtuals traded on CAISO are traded by entities that may be Additional Participants.

FTRs. Financial Transmission Rights or Congestion Revenue Rights as referred to by CAISO (together "FTRs") are "financial instruments that entitle their holders to be paid the congestion costs associated with transmitting a given quantity of electricity between two specified points. A party planning a transmission can thus hedge its exposure to congestion costs by acquiring a corresponding [FTR]. At the time of transmission, the party will pay the [ISO] the applicable congestion costs, but will then receive the same amount back from [the ISO] in its capacity as the holder of the [FTR]." *Sacramento Mun. Util. Dist. v. FERC*, 616 F.3d 520, 527 (D.C. Cir. 2010) (quotation marks omitted). FERC has recognized that "efficient congestion management requires a greater reliance on market mechanisms," and to establish tradable rights for transmission usage which can be used to hedge locational differences in energy prices. See FERC Order No. 2000, 65 Fed. Reg. at 877.

As with virtual transactions, CAISO's and ISO-NE's FTR markets include Additional Participants in addition to LSEs and their suppliers. These entities can purchase FTR rights at regular auctions administered by CAISO and ISO-NE and thus add liquidity to the market. In the CAISO market, 74 participants are authorized to purchase or hold FTRs. Of those, 13 are estimated to be an Additional Participant. In terms of total dollar volume, approximately 6.5% of the FTR payments and charges are with Additional Participants.

ISO-NE. With respect to ISO-NE, as of September 20, 2012, there were 392 active market participants. ISO-NE does not have financials on which to make a determination as to whether 169 of the 392 active market participants would be Additional Participants, however, in each and every instance such Additional Participants are required to post sufficient collateral to cover the risk of their positions. These participants constitute 0.83% of the total gross invoices billed to the 392 active market participants over all ISO-NE markets in 2011. However, of the participants that have filed financial statements with ISO-NE, based on their financial statements, 23 would be Additional Participants. These Additional Participants constitute 3.2% of the gross invoices billed to the 392 active market participants across all ISO-NE markets in 2011. Of these 23 participants, ten (10) representing 2.8% of the total invoices billed to the 392 active market participants in 2011 have met their participation qualification by posting supplemental collateral.

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The liquidity that such Additional Participants bring to the market, particularly in Virtual and FTR transactions, could be non-trivial. As the Commission is aware, insufficient liquidity in a market results in wider bid/ask spreads or greater discontinuity in prices. And, as explained below, the benefit to the market of additional liquidity does not come at the cost of increasing systemic risk or customer protection concerns. Moreover, in the case of ISO-NE, some Additional Participants are engaged in Energy Transactions involving the purchase of electricity. Their participation in the market is necessary and appropriate to the market plan for the efficient and cost-effective distribution of electricity.

III. Petitioners' Participation Standards Adequately Address Systemic Risk and Customer Protection Issues

The Commission decided not to extend the proposed exemption to the Additional Participants in order to “avoid[] potential issues regarding financial integrity and customer protection.” 77 Fed. Reg. at 52146. In the Commission’s view, that approach would limit the exemption “to sophisticated parties that are able to, from a financial standpoint, understand and manage risks.” *Id.* CAISO and ISO-NE respectfully submit that Petitioners’ market safeguards ensure financial integrity for all segments of the markets, including the Additional Participants.

As Petitioners have explained in detail, their FERC-approved tariffs include a number of financial protections—including market monitoring, credit policies, strong risk management controls, and minimum participation standards. These protections mitigate systemic risks, and as the Commission noted, Petitioners’ minimum participation criteria for their markets—which consist of baseline capitalization requirements or financial posting requirements—are “congruent with, and sufficiently accomplish” the Commission’s market protection objectives. 77 Fed. Reg. at 52151.

The Commission decided not to extend the exemption to the Additional Participants based in part on a belief that Petitioners have “an exception to the posting requirement for market participants with small positions.” *Id.* at 52145. However, under their Tariffs, *all* participants without exception must—in addition to posting collateral to cover their open positions—satisfy *either* baseline capitalization *or* financial posting requirements tailored to the market risk they pose. For example, CAISO requires that unless a market participant has a capitalization of \$1 million in tangible net worth or \$10 million in total assets, it must post financial security commensurate with its market risk. A participant with less than six months’ experience on CAISO’s markets must post \$500,000. A participant with more than six months of market activity must post \$100,000 if it has had less than \$100,000 in estimated potential market liability in the last six months, and \$500,000 if such liability exceeds \$100,000. Any such financial security must be in the form of a letter of credit, a cash deposit, a surety bond, a payment bond certificate, or a prepayment to CAISO. CAISO Tariff § 12.1.2 For ISO-NE, each

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market participant must post a minimum “financial assurance obligation” that will be commensurate with its outstanding market risk. The extent of the obligation depends on the precise exposure that the participant currently has on all of ISO-NE’s markets, including the markets for virtual transactions and FTRs. The financial assurance obligation must be posted in the form of a cash deposit or a letter of credit. Accordingly, no market participant is able to participate in the market without meeting a collateral requirement commensurate with the risk that the participant poses to the market.

Moreover, the requirement that a market participant post collateral commensurate with the market risk that it poses helps to ensure that unseasoned traders do not casually enter the markets. These markets are complex and are not geared to unsophisticated traders. Indeed, both CAISO and ISO-NE conduct required training for market participants. These markets are complex, and a threshold level of sophistication is necessary before a market participant will be able to trade. The practical reality that these markets are complex, that they are designed as wholesale, not retail, markets, combined with the Tariff-based requirement that participants post collateral commensurate with the risk that they pose, provides assurance that the Additional Participants will indeed be appropriate persons.

IV. Deeming The Additional Participants To Be “Appropriate Persons” Under Section 4(c)(3)(K) Would Be Consistent With Congressional Intent

Finally, if the Commission has any doubt whether it can exercise its discretion under section 4(c)(3)(K) to deem the Additional Participants “appropriate persons,” the congressional intent behind the provision should resolve that doubt.

The “appropriate persons” definition was added to the Act in the Futures Trading Practices Act of 1992. As noted above, section 4(c)(3) provides both specific and general definitions for the term “appropriate persons.” Under subsections (A)-(J), the term categorically includes several types of institutions that either have a sophisticated understanding of markets or have enough capitalization to withstand market risks. In addition, however, subsection (K) covers “other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections.” It is clear from the legislative history of the Futures Trading Practices Act that Congress intended for subsection (K) to serve as a catch-all provision that complements the specifically enumerated categories. In other words, subsection (K) applies to entities that—because of their own financial sophistication or because of existing regulatory protections—have sufficient safeguards against market risks. As the conference report explained, the provision was intended to apply to entities for which “there are adequate financial or other protections in place against fraud or other illegal conduct.” H.R. Rep. 102-978, at 79 (1992) (conference report).

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The Commission would satisfy that intent if it were to deem the Additional Participants as “appropriate persons” under section 4(c)(3)(K). As explained above, Petitioners have instituted numerous safeguards pursuant to FERC regulations that will protect the financial integrity of their markets and that will shield the Additional Participants from undue market risks. In particular, Petitioners’ minimum participation criteria will help ensure that only sophisticated market players, with a full understanding of the risks of engaging in the Transactions, will enter Petitioners’ markets. Additionally, FERC will have its own enforcement authority over Petitioners’ markets, and the Commission would also retain its powers to patrol the markets for fraud and manipulation.

V. Conclusion.

In the Dodd-Frank Act, Congress requested the Commission and FERC to “apply[] their respective authorities in a manner so as to ensure effective and efficient regulation in the public interest,” “resolv[e] conflicts concerning overlapping jurisdiction,” and to “avoid[], to the extent possible, conflicting or duplicative regulation.” Pub. L. 111-203 § 720, 124 Stat. 1376 (2010). This petition presents the Commission with an opportunity to do so. In light of FERC’s existing and pervasive oversight of the Transactions, the Commission should grant the full requested exemption.

CAISO and ISO-NE submit that the Additional Participants should be considered “appropriate persons” under section 4(c)(3)(K) because they provide helpful liquidity to the markets, which increases the efficient functioning of Petitioners’ markets, and they pose little systemic risk in light of the strong market controls that Petitioners have instituted pursuant to their FERC-approved tariffs—including strong minimum participation criteria that apply to all market participants. As Congress has explained, section 4(c)(3)(K) was intended to apply to entities for which “there are adequate financial or other protections in place against fraud or

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other illegal conduct.” H.R. Rep. 102-978, at 79 (1992) (conference report). Given the effective checks and balances built into Petitioners’ markets through their FERC-approved tariffs, Congressional intent would be met if the Commission under section 4(c)(3)(K) of the Act were to deem the Additional Participants as “appropriate persons.”

Respectfully submitted,



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