Kenneth W. Anderson, Jr.
Commissioner

Public Utility Commission of Texas

February 13, 2012

By: electronic submission

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Board of Governors of the Federal
Reserve System
20th Street & Constitution Avenue, NW
Washington, D.C. 20551

Department of the Treasury
Office of the Comptroller of the Currency
250 E Street, SW
Washington, D.C. 20219

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 (Docket No. OCC-2011-0014 and RIN 1557-AD44; FRS Docket No. R-1432 and RIN 7100 AD 82; FDIC RIN 3064-AD85; SEC Release No. 34-65545, File No. S7-41-11 and RIN 3235-AL07).**

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)[1] put forward by the Office of the Comptroller of the Currency, Treasury (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC) and the Securities and Exchange Commission (SEC) (collectively the Agencies) to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act or the Act).[2] 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, we believe that significant changes to the Proposal will be necessary, particularly with respect to the

[1] *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).

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).

provisions implementing the market-making exemption contained in the Dodd-Frank Act, before final rules are adopted.

Background

The Texas PUC is responsible protecting the public interest inherent in the rates and services of public utilities,[3] 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,[4] (2) that Texas electric utilities and electric cooperatives furnish service, instrumentalities and facilities that are safe, adequate, efficient and reasonable,[5] and (3) that electric utilities and transmission and distribution utilities provide reliable electric service throughout Texas.[6] 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, that covers approximately 75% of the State's land mass and 85% of its electric load. Within the ERCOT region the PUCT is also responsible for preventing market manipulation and other forms of market power abuse.[7]

Central to the efficient operation of the wholesale and retail power markets within the ERCOT region are the ERCOT administered day-ahead market, real-time market and auction of its congestion revenue rights (CRRs), which are ERCOT's form of financial transmission rights 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

[3] Public Utility Regulatory Act, TEX. UTIL. CODE ANN. § 11.002 (Vernon 1998 & Supp. 2011) (PURA).
[4] *Id.*
[5] *Id.* at § 38.001.
[6] *Id.* at §§ 39.352(b) and 39.356(a).
[7] *Id.*, at 39.157; see also P.U.C. SUBST. R. 25.93.

physical risks relating to those activities. As noted in ERCOT's comment letter, of February 13, 2012:

> 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).[8]

The Texas PUC supports and joins in the comments submitted by ERCOT and urges that federal prudential regulators 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 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.[9] 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

[8] *See* ERCOT Comments at 5 (Feb. 13, 2012).

[9] Proposal at 68857.

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 (such as 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.

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. 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.[10] The legislation

[10] Act at Sec. 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

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."[11] 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.[12]

The proposed structure of market-making permitted activity in the Proposal is too narrow and prescriptive.[13] The Proposal has specific criteria, which apply equally across all asset classes and market conditions, which must each be met in order for an activity to qualify as permissible market making.[14] 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 Agencies 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* – 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,

agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine.).

[11] *Id.* at Sec. 13(d) (listing permitted activities); see also Sec. 13(b)(v).

[12] Proposal at 68860.

[13] *Id.* at 68869-70.

[14] *Id.* at 68870.

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 -- ignores the fact that market-makers must hold inventory, which may increase or decrease in value, until a buyer appears.

- *Example*: Market-makers will offer more for a tolling agreement[15] 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 Agencies have 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 Agencies to address them. In addition, once the Agencies have 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

[15] 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, like a rental agreement,

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 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 Agencies 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 Agencies for their consideration of our comments.

Very truly yours,

Kenneth W. Anderson, Jr.
Commissioner