

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20551
RIN No. 3064-AD85

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20219
Release No. 34-65545; File No. S7-41-11;
RIN 3235-AL07

Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1432; RIN 7100-AD82

Department of the Treasury
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219
Docket ID OCC-2011-14; RIN 1557-AD44

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 AD82; FDIC RIN 3064-AD85; SEC Release No. 34-65545, File No. S7-41-11 and RIN 3235-AL07)

Dear Sirs and Madams:

Electric Reliability Council of Texas, Inc. (ERCOT) appreciates the opportunity to comment on the rules proposed by the Federal Deposit Insurance Corporation, Securities and Exchange Commission, Board of Governors of the Federal Reserve System (Board), and Department of the Treasury's Office of the Comptroller of the Currency (collectively, the "Agencies") to implement Section 619 of the Dodd-Frank Wall Street Reform and Customer Protection Act (the "Proposed Rules").

Executive Summary

ERCOT manages electric reliability and administers competitive electricity markets that serve more than 23 million consumers in Texas. As an electricity system operator, ERCOT does not presume to instruct the Agencies on the details of how to navigate the complex set of issues arising under Section 619 of the Dodd-Frank Act. As part of consideration of the Proposed

Rules, however, ERCOT urges that the Agencies be cognizant of avoiding unintended consequences that would negatively impact the efficiency of competitive electricity markets.

A key element of contemporary competitive electricity markets is the availability of financial hedging instruments that both facilitate the management of risk by electric industry market participants and promote healthy liquidity in the markets. These markets are comprehensively regulated by federal and state regulators, and provide important benefits to consumers of electricity.

Similar to any market, liquidity in organized electricity markets is necessary to promote price efficiency. ERCOT's review of the Proposed Rules raises concerns that, as drafted, the rules may discourage continued participation by banking entities in transactions in organized electricity markets, which could negatively impact liquidity. Currently, several banking entities are significant participants in the ERCOT market. The elimination of banking entities as market participants could undermine market efficiency and the corresponding economic benefits that flow through to end use consumers.

To mitigate this potential, unintended result, ERCOT urges the Agencies to ensure that the statutory "market-making" exception to the prohibition on proprietary trading is defined to permit existing participation by banking entities in organized electricity markets like the one administered by ERCOT.

Background: The ERCOT Market Structure

ERCOT serves as the Independent System Operator (ISO) for most of the Texas,¹ representing 85 percent of the state's electric load and serving more than 23 million customers. ISOs were developed as a means of facilitating electric transmission open access, with the intent

¹ Public Utility Regulatory Act, TEX. UTIL. CODE ANN. § 39.151 (Vernon 1998 & Supp. 2010). There are seven ISOs/RTOs (Regional Transmission Organizations) in the United States. In addition to ERCOT, other ISOs/RTOs include: PJM Interconnection, LLC; California ISO; ISO New England; NYISO; Midwest ISO; Southwest Power Pool. ERCOT is subject to the jurisdiction of the Public Utility Commission of Texas for market and reliability (*i.e.*, operations and planning) matters, and the Federal Energy Regulatory Commission (FERC) for certain reliability standards. All other US ISOs/RTOs are subject to FERC jurisdiction for market and reliability matters.

of promoting competition for wholesale electricity supply in a restructured market. As with other ISOs, ERCOT has the responsibility of facilitating the development and administration of efficient markets, but does not have a financial interest in market outcomes. ERCOT is a non-profit, membership-based organization comprised of a variety of market participants, including, but not limited to, consumers, cooperatives, generators, power marketers, retail electric providers, investor-owned utilities, and municipal-owned utilities; its interest is in the efficient and reliable operation of the electric grid and the markets that support that function. As an ISO, ERCOT does not favor the interests of any one segment of the market.

As the ISO for its region, ERCOT schedules power on an electric grid that connects 40,500 miles of transmission lines and more than 550 generation units. One of ERCOT's main goals as an organized market is to maintain conditions in which prices reflect the true cost of electricity. This is accomplished by utilizing Locational Marginal Prices (LMPs), which price electricity based on the marginal cost of producing and consuming power at specific locations on the electric grid. Price separation between LMPs occurs as a result of system congestion, which essentially reflects the need to use more expensive generation to serve load because transmission constraints prohibit the use of less expensive generation on the wrong side of a transmission constraint. Congestion costs are reflected in LMPs, which are prices charged to consumers that consume power at the various locations on the electric grid.

The reflection of congestion costs in LMP pricing created the need for a hedging mechanism to enable parties to manage the financial uncertainty associated with congestion (which varies on a frequent, close to real-time basis, based on overall electric system conditions). By creating financial rights independent of the physical dispatch of the electric system, ERCOT and other ISOs can employ Security Constrained Economic Dispatch (SCED) determinations, thereby achieving economic and operational efficiencies on the electric grid, while still providing price certainty for buyers and sellers of electricity.

To facilitate its market functions, ERCOT operates day-ahead and real-time energy markets. The day-ahead market is, in essence, a financial market that allows market participants to hedge their real-time exposure by managing their financial exposure for their supply and/or

demand market positions. The real-time market is a physical balancing market that purchases supply to manage supply-load imbalances relative to the day-ahead market. As discussed above, financial transmission rights provide an additional means of hedging congestion costs. It is the day-ahead and transmission rights markets that may be impacted by the proposed rule.

In Real-Time Market operations, ERCOT dispatches resources based on economic offers of energy from resources to meet system demand, while observing resource and transmission system constraints. To determine the least-cost dispatch of online resources, SCED models run every five minutes to evaluate desirable generation resource output levels, by using offers from individual resources and actual shift factors from resources on transmission elements, which create the congestion shadow price component in the LMPs. Generation pricing is then determined by the LMP of each node (*i.e.*, point of generation at a generator) on the grid, and load zone pricing is determined by the weighted average of LMPs in a particular load zone.

ERCOT's Day-Ahead Market is a voluntary, but financially-binding energy market that enables market participants to manage their portfolios (*i.e.* market positions - load and/or supply) by locking in prices on a day-ahead basis. This permits buyers and sellers of electricity to make arrangements to mitigate price volatility risk during the next day's real-time operations. In organized electricity markets, the convergence of Day-Ahead and Real-Time prices is an indication that the market is operating efficiently.

Congestion Revenue Rights (CRRs)² are financial instruments that result in a charge or a payment to the holder of the right based on the price differential between two different price points on the electricity transmission system. CRRs can be used as financial hedges relative to actual market positions, or they can be purchased as financial instruments unrelated to physical market positions. When used as a hedge, a CRR mitigates exposure to congestion because it pays the holder an amount equal to the congestion charges assessed to that party. In essence, the entity's congestion charges and CRR credits cancel each other so the participant is not exposed

² Other ISOs also utilize instruments serving the same purpose as ERCOT's CRRs. These instruments go by various names, including "Financial Transmission Rights," or "FTRs" in other ISO markets.

to congestion costs. When purchased as an investment, the holder simply receives the CRR credits or charges, depending on whether the value is positive or negative.³

Similar to any market, the efficiency of organized electricity markets is impacted by the liquidity of the relevant market. In order to facilitate liquid markets, both the day-ahead and financial transmission rights markets accommodate entities – *e.g.*, financial institutions - to participate solely on a financial basis. With respect to the day-ahead market, such entities hope to capture the value between the day-ahead and real-time prices. This enhances the liquidity of the day-ahead and real-time markets and facilitates price convergence between the two markets, thereby increasing market efficiency. Allowing similar financial participation in the transmission rights market provides comparable efficiency benefits. Thus, it is in the interest of organized markets to support this type of activity in its markets to support efficient pricing outcomes, the benefits of which inure to end-use customers. As discussed in greater detail below, ERCOT believes the Proposed Rules could affect the liquidity of its markets. Accordingly, ERCOT urges the Agencies to consider these comments and revise the final rule accordingly in order to mitigate any potential negative impact to organized electricity markets.

The Role of Banking Entities in the ERCOT Market

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

³ The value of financial transmission rights can be positive or negative based on the prevailing flow on the transmission system relative to the CRR pathway.

supply of power.⁴ In addition to making investments in and providing hedges for major capital projects, banking entities also play a significant role in facilitating efficient market outcomes. These entities participate in the relevant markets, and, in so doing, they serve an important function in providing and preserving liquidity in the ERCOT market.

Banking entities operate as “power marketers” in ERCOT and other organized electricity markets. Some power marketers are associated with companies that own electric generation assets. In that role, power marketers seek to enhance value by maximizing the efficiency of the use of the assets. For example, power marketers associated with generation owners will run models that assess supply and demand positions in various locations on the ERCOT system – models that may include variables for factors like fuel prices, number of planned outages, and weather conditions. Using these data, the power marketer determines where and when to purchase CRRs, and what other steps should be taken to mitigate the risk of the generation unit running at a time that does not maximize return on the use of the asset. This type of risk mitigation can be extremely important to the financial viability of a generation asset if the unit experiences an unplanned outage and cannot deliver power as planned. Unhedged generation owners can face tremendous financial losses if weather events, mechanical failures, or other unexpected events prevent their scheduled delivery of power.

Power marketers also work with retail electric providers in the areas of Texas where there is active retail electric service competition. Power marketers offer risk management strategies, which may include purchasing and holding CRRs from ERCOT, or hedging instruments obtained independent of ERCOT (*e.g.*, energy options, swaps, or forward contracts). In this way, the marketer helps the retailer who, for example, wants to offer a single flat rate, but needs to manage the variations in the cost of electricity the retailer must pay to serve its load.

In addition, power marketers may participate in the relevant markets independently of asset owners or retailers. For example, in the energy markets, they can take market positions to

⁴ The ERCOT region set a new peak demand record on August 3, 2011 (63,379 megawatts). The previous demand record – set in August 2010 – was broken on three different days in August 2011. While ERCOT currently has sufficient generation resources to meet anticipated needs for 2012, ERCOT and its regulators have significant concerns about the need for development of new sources of electric generation. Maintaining an attractive environment for electric industry investment is critical for both the short-term and long-term needs of consumers in the ERCOT market region.

capture the value of expected price separation between the day-ahead and real-time markets. With respect to the transmission rights market, these entities can buy CRRs based on their forecast of the expected value of those rights. From the perspective of the broader market, as noted above, participation in the energy markets facilitate price convergence, which promotes efficiency in the overall ERCOT market.

The activity of power marketers presents what ERCOT submits is a classic case of “market-making.” In order to effectively do their jobs, power marketers must be in a position to buy and hold hedges and CRRs that are inherently short-term in nature. Organized electricity markets need such market-makers to intermediate risk and provide reliable liquidity. In order to serve this function, market-makers need the flexibility to warehouse, enter into wholesale power transactions, and hedge the risks that impact power delivery. A banking entity, like any other participant in the ERCOT market, plays a necessary role in market-making by enhancing liquidity and all the corresponding benefits, such as price discovery.

The Proposed Rules Threaten To Disrupt Market-Making Activity in ERCOT

ERCOT is concerned that the Proposed Rules, if implemented as published, would encourage banking entities to exit the ERCOT market, rather than risk undertaking a transaction that is presumed prohibited under the Act. In particular, the proposed presumption that a bank’s holding an instrument less than sixty (60) days means the bank is engaged in prohibited proprietary trading could effectively eliminate banking entities from participation in ERCOT’s Day-Ahead and Real-Time Markets, and in shorter-term CRR transactions. If this restriction is adopted as proposed, ERCOT expects that existing market participants, who provide useful services to generation owners, retail electric providers, as well as developers of new generation assets, will be forced to eliminate legitimate market-making activity in ERCOT.

ERCOT is hopeful that this potential consequence can be mitigated in the final rule. As the Dodd-Frank Act provides, and the Agencies acknowledge in the published version of the Proposed Rule, market-making activity is not the target for the proprietary trading limits

underlying the Section 619 revisions to the Bank Holding Company Act.⁵ The proposed rule specifically states that the regulation is not intended to impact market-making and traditional asset management services. Banking entities, acting as power marketers, serve these functions in the ERCOT market, and, therefore, to the extent the Proposed Rule would inhibit their willingness to perform these functions, it would be inconsistent with the stated purpose of the rule.

For example, as drafted, the Proposed Rules' definition of market-making is extremely narrow and prescriptive. The specific criteria that determine whether an activity qualifies as market-making apply regardless of asset classes or the particular markets involved. The rigid application of such criteria could easily convince existing banking entity market participants in ERCOT that participation in current activities could run afoul of the new rules – even though nothing in the rules is directly applicable to organized wholesale or retail electricity markets.

Moreover, it is not clear whether the Proposed Rule creates a presumption of proprietary trading that must be rebutted. If every transaction a banking entity undertakes in a market like ERCOT's is presumed to be prohibited subject to a case-by-case rebuttable presumption, the compliance risk of participation in the market could easily outweigh the benefits of continued participation – even though the evils the rules seek to prevent are not implicated by banks' current market-making activities in organized wholesale electricity markets.

⁵ From the Preamble to the Proposed Rules: "The Agencies appreciate that while it is crucial that rules ... clearly define and implement [Bank Holding Company Act, Section 13] requirements, any rule must also preserve the ability of a banking entity to continue to structure its businesses and manage its risks in a safe and sound manner, as well as to effectively deliver to its clients the types of financial services that section 13 expressly protects and permits. These client-oriented financial services, which include underwriting, market making, and traditional asset management services, are important to the U.S. financial markets and the participants in those markets, and the Agencies have endeavored to develop a proposed rule that does not unduly constrain banking entities in their efforts to safely provide such services." 76 Fed. Reg. at 68849 (Nov. 7, 2011).

Conclusion

ERCOT fully appreciates the complexity of the task before the Agencies in implementing Section 619 of the Dodd-Frank Act. As noted at the outset of our comments, ERCOT does not presume to tell the Agencies how to write rules that broadly impact the financial markets overseen by the Agencies. ERCOT files these comments to bring attention to the potential impact of the rules as drafted on what are currently sound, well-functioning, competitive electricity markets.

As the Agencies consider final rules, ERCOT respectfully request that the rules include adequate flexibility to ensure that participation in ERCOT's markets is not affected by chilling the participation of banking entities that currently provide valuable market-making functions. In addition, ERCOT requests that the Agencies provide a sufficient implementation timeline to permit organizations like ERCOT to manage any necessary transitions so as not to disrupt legitimate activity that serves the market-making and asset management purposes that the Agencies have stated the rules are not intended to disturb.

ERCOT appreciates the opportunity to comment on the Proposed Rules, and will provide additional information about ERCOT markets if requested by the Agencies.

Dated: February 13, 2012

Respectfully submitted,

/s/ Bill Magness _____
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