



Commodities Exchange Act Exemption

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Commodities Exchange Act Exemption: Summary

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As authorized by the Board in May, ERCOT plans to seek a Commodity Exchange Act exemption from the CFTC. ERCOT is working with the other ISOs/RTOs on specific compliance terms and filing requirements.

- Expected issues raised by implementing changes that may be necessary to receive the exemption
- Third party Central Counter-Party proposal
- Next steps

Commodities Exchange Act Exemption: Expected Conditions of CFTC CEA Exemption

- 1. ERCOT becomes central counter-party (CCP)**
- 2. Setting criteria for market participation**
- 3. Reduced settlement window for real-time market**
- 4. Two-day limit to 'cure' collateral calls**
- 5. Elimination of unsecured credit for CRR market**
- 6. Limitation on unsecured credit of \$50 million**
- 7. Disallowance of netting between CRR and non-CRR markets**

Commodities Exchange Act Exemption: Expected Conditions of CFTC CEA Exemption

1. ERCOT becomes central counter-party (CCP)

- Expected to enhance ERCOT's position in bankruptcy due to clarification of ability to enforce set-off rights. Most practical of the options possible after FERC Order 741.**
- Operational costs associated with changes to Protocols, Standard Form Agreement, and certain debt covenants.**
- ERCOT is preparing to seek IRS confirmation that this will not impact 501(c) tax-exempt status.**

Commodities Exchange Act Exemption: Expected Conditions of CFTC CEA Exemption

1. ERCOT becomes central counter-party (CCP)

- No decision to date on establishment of a separate legal entity for transacting (e.g. PJM Settlements)
- Potential change in accounts to reflect gross positions
 - Other ISOs/RTOs likely to or are using net basis
 - Require clarification of impact in bankruptcies
 - Potential costs associated with additional testing by external auditors
- Discussions will be started with banks, ratings agencies and noteholders to inform and address issues
- There are no indications to date that assumption of the CCP role materially increases ERCOT's risk profile
- Consultations underway with PUCT staff

2. Setting eligibility criteria for market participation

- **FERC left the initial development of market participation criteria to the ISOs/RTOs, but with the expectation that standards would address:**
 - Expertise in risk management and ISO/RTO markets
 - Ability to respond to ISO/RTO direction
 - Adequate capitalization

2. Setting criteria for market participation

- **Individual ISOs/RTOs are developing criteria through their respective stakeholder processes.**
 - Management certification - Annual officer certification attesting to
 - Sufficiency of risk management capabilities
 - Written policies, procedures and controls
 - Framework to identify the risks to which the participant is exposed
 - In some cases, requirements for appropriate segregation of duties and use of specified risk metrics
 - Expertise in an ISO/RTO market
 - Participants must have traders complete market training
 - Traders in financial products must attend product-specific training
 - New applicants must complete training prior to participation
 - ERCOT will be developing training requirements with stakeholders and PUCT

2. Setting criteria for market participation

- Ability to respond to ISO direction
 - Adequate operating procedures and technical abilities to respond

- Adequate capitalization
 - \$1 million tangible net worth (parent level), or
 - \$10 million in assets, or
 - Up to \$500,000 in additional collateral requirements for participants not meeting capitalization standards
 - There is considerable variation in the ISO/RTO proposals with respect to the final point, with generally lower requirements for non-FTR activity

2. Setting criteria for market participation

- **Failure to meet criteria or provide information would constitute default**
- **Some differences in specific proposals, e.g.**
 - Specific review of policies and controls
 - Investment grade rating
 - Third party transacting
 - Use of specific risk metrics and methodologies
 - PJM proposes tariff language specifying that false or incomplete statements could lead to enforcement action and/or civil or criminal legal action
 - Potential exception items:
 - Adverse information
 - Ratings downgrade
 - Restatement of financials
 - Default in another organized market
- **Supplemented by informational disclosures**

2. Setting criteria for market participation – Risk impacts

- **CFTC and FERC staff have indicated that risk management rules will require some degree of verification by the ISO/RTO of Market Participant risk management capabilities, however there is no specific proposal in this respect.**
- **Impacts:**
 - Compliance monitoring
 - Management of additional collateral
 - Protocol revisions
 - Potential system upgrades
 - Provision of training for market participants
- **ERCOT will be discussing participation criteria with stakeholders and PUCT as requirements become clearer.**

3. Reduced settlement window for real-time market

- Day Ahead Market is already compliant with expected 14-day settlement and payment requirement
- NPRR347 (Counter-Party Invoice and Single Daily Settlement Invoice) is expected to bring approximately 82% of settlement days for Real Time market activity within a 16 day window

3. Reduced settlement window for real-time market

- **We are considering ways to further shorten the Real Time settlement and payment period. For example,**
 - **Reducing one day from settlement time line and one day from the payment period would result in 88% of operating days being settled within a 14 day window.**
- **Potential impacts**
 - **Automated Clearing House (ACH) payment timing**
 - **Maintaining data integrity in the settlements process**
 - **Protocol revisions required**

4. Two-day limit to 'cure' collateral calls

- ERCOT believes it is already compliant with this provision
- No material risk impact anticipated from this provision

5. Elimination of unsecured credit for CRR market

- **At May 31, 2011, a total of 64 counterparties have unsecured credit available either directly or indirectly through guarantees. Of the 38 entities that also have CRR activity, 15 have CRR activity that would require collateral (remaining 23 have credits from CRR activity)**
- **Elimination of unsecured credit in the CRR market**
 - Would increase collateral requirements by approximately \$4.0 million for CRR FCE (as of May 31, 2011)
 - ERCOT expects a more significant dollar impact when CRR auctions extend beyond monthly auctions
 - Likely will also have an impact on MPs in the CRR Auctions
- **Protocol and system changes are needed to implement this provision**
- **Operational risk entailed by this change is manageable**

6. Limitation on unsecured credit of \$50 million

- **At May 31, 2011, fifteen counterparties have unsecured credit, either directly or indirectly through guarantees, in excess of \$50 million (across all markets) for a total of \$1.057 billion. The related Total Potential Exposure (TPE) for these entities is \$157 million.**
- **Based on activity and balances as of May 31, 2011, reducing the cap to \$50 million would reduce unsecured credit for these entities by approximately \$307 million to \$750 million.**
- **Operational risk entailed by this change is manageable.**

7. Disallowance of netting between CRR and non-CRR markets

- **Currently netting between CRR and non-CRR markets is restricted to counterparties from whom ERCOT has a first priority security interest or who are either an Electric Cooperative or an Entity created under TWC § 222.001.**
- **As of May 31st, only 11 Counter-Parties or approximately 5% of CPs are allowed to net between CRR and non-CRR markets.**
- **Operational risk entailed by this change is manageable.**

Any additional risks identified as the exemption application process progresses will be communicated to the Board, the PUCT, and Market Participants as they arise.

Commodities Exchange Act Exemption: Third Party Central Counter-party

- **ERCOT staff have met with NASDAQ-OMX to discuss NASDAQ's proposal to act as a third party central counter-party on behalf of ERCOT**
- **Under the proposal NASDAQ would act as the counter-party in all ERCOT market transactions**
- **No fees to either side**
- **As proposed, ERCOT would continue to:**
 - Execute all credit, invoicing and settlement functions
 - Provide market services
 - Administer market Protocols
- **NASDAQ will not take on risk positions**
- **Structure intended to be similar to PJM – PJM Settlements relationship**

Commodities Exchange Act Exemption: Third Party Central Counter-party

- **NASDAQ intends to offer joint NASDAQ / ERCOT market participants the option to avail of netting with NASDAQ OTC market receivables (not forward exposures)**
- **Identified risk issues:**
 - Lack of clarity with respect to position set-off in the event of bankruptcy if ERCOT and third party OTC receivables are netted.
 - Can ISO functions as mandated under PURA be delegated?
 - Use of ERCOT personnel may lead to a situation where the private benefit to NASDAQ may be deemed to exceed the public benefit of the proposed NASDAQ arrangement.
 - Tax exemption issues with a not-for-profit entity subcontracting material activities to a for-profit organization.

Commodities Exchange Act Exemption: Next Steps

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- **Discussions regarding CEA exemption application are ongoing in stakeholder meetings**
 - Credit Working Group Meeting
 - May 25th 2011
 - June 9th 2011
 - Technical Advisory Committee Meeting
 - June 2nd 2011
 - CFTC Credit Workshop
 - June 16th 2011

Commodities Exchange Act Exemption: Next Steps

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- **PUCT discussion at June 17, 2011 Open Meeting (Project No. 39484)**
- **CFTC staff has proposed a timeline contemplating ISO/RTO exemption filings in early July**
- **Based on July filings, publication of proposed exemption order anticipated late July – early August**
- **Final exemption order publication expected end of October**
- **IRS briefing paper prepared in cooperation with other ISOs/RTOs**
- **Filing of IRS submission expected in July**
- **IRS determination expected prior to end of year**

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Questions?