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3890 Carman Road • Schenectady, New York 12303

William J. Museler
President and Chief Executive Officer

(518) 356-6070
(518) 356-4702 (fax)
e-mail: wmuseler@nyiso.com

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OFFICE OF THE SECRETARIAT August 21, 2000

Electronically and By Facsimile

Commodity Futures Trading Commission
3 Lafayette Centre
1155 21st Street NW
Washington, DC 20581
Attn: Office of the Secretariat

COMMENT

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Re: Proposed Rulemaking: Regulatory Reinvention

Dear Ladies and Gentlemen:

The New York Independent System Operator ("NYISO" or the "System Operator") submits this comment with respect to the Commission's notice of proposed rulemaking (the "Proposed Rules" or the "Proposal") concerning multilateral transaction execution facilities ("MTEFs") and clearing organizations published on June 22, 2000 at 65 Federal Register 38985.

NYISO is an entity formed pursuant to orders of the Federal Energy Regulatory Commission ("FERC")¹ for the purpose of assuring the reliability of the bulk power system in New York State (the "NYS Power System"), facilitating wholesale competition by ensuring open, non-discriminatory access to New York State's transmission facilities and operating wholesale electric power markets for energy, capacity, transmission and ancillary services within the NYS Power System ("System Operator Markets"). The System Operator's members include all of the owners of electric transmission facilities located in New York State as well as generators and other wholesale suppliers and purchasers of electric power.

In view of the uncertain jurisdictional reach of the Commodity Exchange Act ("CEA") over wholesale markets for future delivery, the System Operator has a strong interest in assuring that in

¹ *Central Hudson Gas & Elec. Corp. et al.*, 83 CCH FERC ¶ 61,352 (1998) (conditionally authorizing the formation of the NYISO); *order on reh'g*, 87 CCH FERC ¶ 61,135 (1999). See also *Central Hudson Gas & Elec. Corp., et al.*, 86 CCH FERC ¶ 61,062 (1999) (conditionally approving the NYISO's tariffs and market rules); *order on reh'g*, 88 CCH FERC ¶ 61,138 (1999).

the event that CEA jurisdiction should be determined to extend to any of its future sales markets,² that such markets, and any related clearing services provided by the System Operator, will remain exempt from Commission regulations and oversight, as is clearly appropriate in view of the special nature of those markets and FERC's primary regulatory oversight.

The Proposal appears to have a deregulatory purpose. However, it falls short of that purpose when it comes to System Operator Markets. NYISO believes that the Proposal would establish arbitrary and unduly restrictive standards for eligibility as an Exempt Multilateral Transaction Execution Facility ("Exempt MTEF"), that is, the class of markets that are automatically exempt from all but very limited CEA provisions. NYISO also finds unduly restrictive and burdensome the Proposal's requirement that, if contracts entered into through an Exempt MTEF are cleared (that is, all contract performance is assured by a single specified third party), the clearing facility will be deemed to be a "contract market" subject to CEA jurisdiction and must be authorized and overseen by the Commission as a "recognized clearing organization" ("RCO"), or by either the Securities and Exchange Commission ("SEC"), a domestic banking regulator or an approved foreign regulatory authority. Finally, while NYISO supports the Proposal's inclusion of a general provision for seeking exemption from the Proposed Rules, NYISO believes it advisable to also include the standards upon which the Commission will determine to grant a petition for exemption, particularly the Commission's standards for Exempt MTEF status.

As explained below, assuming that certain System Operator Markets are, or may in their later development become, subject to the CEA, it would be both fair as well as appropriate from a public policy perspective that these FERC regulated markets receive Exempt MTEF status and that FERC approval of the System Operator's provision of clearing services be given the same respect and status as that given to the other regulators specified in the Proposal. In that regard, NYISO respectfully urges that the Proposed Rules be improved by (1) expanding eligibility for automatic Exempt MTEF status in a manner that will include all wholesale System Operator Markets subject to FERC oversight; (2) providing that a FERC regulated public utility, such as the System Operator, shall be permitted to clear wholesale electric transmission and power related contracts relating to its own power system without Commission approval as an RCO; and (3) providing useful guidance as to the Commission's standards for granting petitions for exemption.

System Operator Markets Should Be Automatically Exempt

According to the Proposed Rules, in order for a market to qualify for automatic Exempt MTEF status, the contracts traded must be based on one of the following commodities: (a) a debt obligation; (b) a foreign currency; (c) an interest rate; (d) an exempt security; (e) a measure of credit quality; (f) an occurrence or contingency beyond the control of the counterparties; or (g) cash-settled based upon an economic or commercial index or measure (the "Eligible

² System Operator Markets which involve spot delivery are outside any possible claim of CEA jurisdiction.

Commodities")³, and market participants must be limited to certain specified types of financial institutions, individuals regulated by the Commission or otherwise to persons having specified minimum financial qualifications ("Eligible Participants").⁴ NYISO submits that the definition of Eligible Commodities and of Eligible Participants, which effectively exclude the System Operator Markets from Exempt MTEF status, are arbitrary and overly restrictive, because they lack an articulated basis for excluding markets such as the System Operator Markets and fail to take into account the special regulatory oversight, design and participation criteria which make the System Operator Markets resistant to price manipulation and free of customer protection concerns.

Pervasive FERC regulation makes Commission regulation duplicative and unnecessary for System Operator Markets. The System Operator, which is a "public utility" under the Federal Power Act (the "FPA")⁵ was established pursuant to a FERC order.⁶ Consequently, the System Operator and FERC both have a statutory obligation to ensure that System Operator-administered markets operate in a non-discriminatory manner and produce "just and reasonable" prices,⁷ *i.e.*, prices that are not the result of market power or manipulation.⁸ Thus, in order to establish each System Operator Market, FERC required the System Operator to submit in advance a detailed description of the market, its rules, mechanisms and participants, and to demonstrate that it was designed to mitigate the adverse effects of market power.⁹ In addition, the System Operator, is responsible for monitoring the operation of its markets and cannot vary any market's material terms without advance FERC approval.¹⁰ FERC has the authority to require any System Operator Market rule

³ Proposed Rule 36.2(b)(1)-(7).

⁴ Proposed Rules 36.1(a) and 35.1(b)(1)-(11).

⁵ 16 U.S.C. § 791a-825r (1994)

⁶ *See supra* n.1

⁷ *See* FPA § 205(a), 16 U.S.C. 824(d).

⁸ *See, e.g., See, e.g., Elizabethtown Gas Co. v. FERC*, 10 F. 3d 866, 870 (D.C. Cir. 1993) ("when there is a competitive market the FERC may rely upon market-based prices . . . to ensure a 'just and reasonable' result.") (emphasis added).

⁹ *See, e.g.,* 86 CCH FERC ¶ 61,062 (1998) (requiring the NYISO's proponents to provide further justification and additional detail concerning the proposed NYISO installed capacity market design.) *See also, New York Independent System Operator, Inc.*, 89 CCH FERC ¶ 61,109 (1999) (providing additional guidance and requiring additional revisions to the NYISO's installed capacity market design proposal); *New York Independent System Operator, Inc.*, 90 CCH FERC ¶ 61,319 (2000) (accepting the NYISO's transitional installed capacity market design proposal, but requiring an additional compliance filing).

¹⁰ *See Central Hudson Gas & Electric Corp.*, 86 CCH FERC ¶ 61,062 (1999) ("We agree that there should be an ISO monitoring program that should identify both market power and market design flaws."); *New* (continued...)

to be modified or withdrawn. In fact, FERC has required another independent system operator to impose temporary price caps on certain markets, despite its objections, as a means of correcting market flaws,¹¹ and has also authorized that same system operator to terminate an unworkable market.¹² Furthermore, FERC is, of course, the single expert federal agency with respect to the electric power industry. FERC is uniquely qualified to understand and evaluate proposed public utility power related markets and their rules, as well as the operation of those markets, transaction prices and the qualifications of market participants.

More generally, FERC recently initiated a comprehensive investigation of wholesale power markets, including all System Operator markets, to: (i) determine which are working well; (ii) find ways to improve those that are not; and (iii) to better understand, and if appropriate remediate, the high levels of price volatility observed in some wholesale power markets.¹³ FERC has also indicated that it will work closely with California regulators to ensure that problems that have arisen in that state's wholesale power markets this summer are addressed effectively.¹⁴ Deregulation of the electric power industry in the United States is in its infancy, as is the development of competitive wholesale markets for electricity. It involves many issues that are unique to that industry but which are well known to FERC. These efforts should not be suffocated by an additional level of federal regulation.

In addition, although FERC is the primary regulator of wholesale power markets, its market monitoring efforts are reinforced by the federal antitrust agencies which are carefully tracking market developments.¹⁵ The antitrust agencies have also communicated informally with the

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York Independent System Operator, Inc., 90 CCH FERC ¶ 61,317 (2000) (conditionally approving the NYISO's revised market power monitoring and mitigation plan.) The NYISO has an internal market-monitoring unit responsible for market power monitoring and mitigation, reinforced by an outside, independent market power advisor.

¹¹ *NSTAR Services Company v. New England Power Pool*, 92 FERC ¶ 61,065 (2000) (Imposing temporary bid caps on markets administered by ISO New England in order to mitigate the effect of market design flaws.)

¹² FERC has authorized ISO-New England to terminate its operable capability market after the ISO had determined that the market was dysfunctional. In addition, FERC has authorized material modifications to the ISO-New England installed capacity market to correct certain structural flaws. See, e.g., *ISO New England, Inc., et. al.*, 91 FERC 61,311 slip op. at 47-48 (2000).

¹³ *Investigation of Electric Bulk Power Markets*, 92 FERC ¶ 61,150 (2000).

¹⁴ See, e.g., *Letter from FERC Chairman James J. Hoecker to California Governor Gray Davis* (August 2, 2000).

¹⁵ See, e.g., *United States Federal Trade Commission, Staff Report: Competition and Consumer Protection*
(continued...)

market monitoring units of various System Operators and pledged to help to ensure that System Operator markets remain competitive. The involvement of the antitrust agencies further ensures that consumers will be protected from market power abuses and further diminishes the need for CFTC involvement.

The System Operator Markets, that have been approved by FERC, are no less, and very likely more, resistant to price manipulation than are several, if not all, of the Proposal's markets for Eligible Commodities.¹⁶ We note that the Commission's "New Regulatory Framework" which was transmitted to the Commission's Congressional oversight committees on February 22, 2000, relied upon the existence of a nearly unlimited supply as the litmus test for an Eligible Commodity. Yet without explanation the Proposal includes debt instruments, credit swaps and exempt securities among the commodities eligible for exempt market status. The Proposal does not suggest that any of these has a nearly unlimited supply, or discuss their supply at all. Indeed, NYISO submits that the supplies of these commodities (e.g., loans) are likely to be more limited than the power related supplies available in the System Operator Markets. This, plus the absence of any assurance of regulatory oversight, such as FERC provides to the System Operator Markets, raises serious questions as to why the System Operator Market's power related commodities are excluded from those eligible for Exempt MTEF status. For these reasons, we urge that power and related services when traded on a System Operator Market be included among the Eligible Commodities. At a minimum, to avoid the appearance of arbitrariness, the Commission should publish its analysis explaining how it has selected the Eligible Commodities.

NYISO further believes that the list of Eligible Participants is unnecessary and unfairly weighted toward financial market participants. NYISO submits that participants in System Operator Markets, all of whom are engaged in the electric power business¹⁷ are no more in need of protection than those persons listed among the proposed Eligible Participants. The proposed

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Perspectives on Electric Power Regulatory Reform (July 2000).

¹⁶ Moreover, in the event that an entity was able to exercise market power in an Independent System Operator-administered market the relevant Independent System Operator would be able to take action, reinforced by FERC, to correct the problem. See, e.g., *AES Redondo Beach, L.L.C., et al.*, 84 CCH FERC ¶ 61,046 (1998), *order on reh'g*, 85 CCH FERC ¶ 61,123 (1998) (waiving normal procedural rules and approving the California ISO's emergency actions to correct market design flaws in its ancillary services markets).

¹⁷ For example, pursuant to the NYISO's Market Administration and Control Area Services Tariff ("ISO Services Tariff"), which has been reviewed and approved by FERC, *see supra* n.1, any entity that proposes to purchase or sell energy, capacity or ancillary services in a NYISO-administered market must comply with all of the requirements (including creditworthiness standards) established under the ISO Services Agreement and must execute a Service Agreement with the NYISO.

Eligible Participants include banks, savings, and loan associations, and credit unions, insurance companies, broker dealers, futures commission merchants and natural persons who are commodities floor brokers or floor traders, all without regard for their experience with the particular commodity, whether or not their business involves the relevant market and irrespective of their financial condition.¹⁸ In contrast, a power related business, such as a power marketer authorized by FERC to sell power at market-based rates, would receive no similar treatment — even if it were trading in a power related commodity. The Proposal provides no explanation or analysis as to why it has so limited the Eligible Participant list, and we know of no reasonable basis to require a power marketer, or other electric industry company, trading in power, capacity or transmission to meet specified financial requirements when financial industry participants, including individuals, need not.¹⁹

Clearing Organizations

Proposed Rule 39.1(a)(i) would define a "clearing organization" as one performing a credit enhancement function for transactions executed either on a Commission designated contract market, a less regulated derivative transaction facility, an exempt METF or pursuant to an exempt swap facility by either (i) becoming an universal counterparty to a market's participants or (ii) operating to net obligations and payments for such transactions. Further, each such clearing organization would be required to become a "Recognized Clearing Organization" subject to CFTC rules and oversight, except that Exempt MTEFs and swap facilities could also be cleared by certain other specified types of entities. The Proposal's other permitted clearing entities, including: (1) SEC supervised securities clearing agencies; (2) a bank, bank subsidiary, bank affiliate, or certain foreign affiliates of banks,²⁰ and (3) certain qualifying foreign clearing organizations, are apparently exempt from RCO requirements due to being otherwise regulated. As explained below, the proposed regulatory burden on a RCO is a heavy one, and one not appropriate or reasonably necessary should the System Operator act as the universal counterparty to market participants engaged in transactions relating solely to the System Operator's own power system, a system for which the System Operator is required by FERC to ensure reliability.

¹⁸ See Note 4 above.

¹⁹ Because of (a) FERC prior approval requirements, including requirements that the System Operator Markets be designed to resist market power manipulation and monitored by the System Operator for any design flaws that could facilitate market power manipulation and for evidence of any such abuse, and (b) limitation of market entrants to persons engaged in the wholesale electric power business, the System Operator Markets are at least as resistant to price manipulation as are markets for the proposed Eligible Commodities, and as lacking in the need for customer protection requirements, as markets restricted to the proposed Eligible Participants.

²⁰ The Proposal includes Edge Act corporations, which are organized, chartered and examined by the Federal Reserve to engage in international banking operations.

An RCO, which under the Proposal is deemed to be a “contract market” regulated under the CEA, must adhere to fourteen specified core principles. These principles relate to the following: financial resources; participant and product eligibility; risk management; settlement procedures; treatment of client funds; default rules and procedures; rule enforcement; system safeguards; governance; reporting; recordkeeping; public information; information sharing and competition. The text of an Appendix A to the Proposed Part 39 further reveals that there are at least seventy-five distinct Commission mandated standards that must be satisfied by an RCO. It is clear that the regulatory burden on a RCO will be substantial. This is an unnecessary burden when (1) the System Operator may offer itself as a universal counterparty solely with respect to transactions involving its own power system for the purpose of being better able to monitor and ensure system reliability and (2) another federal regulator, that is, FERC, the expert agency for power markets, has already reviewed and approved this special role of the System Operator. The Proposal already recognizes and respects the oversight of other regulators, including foreign regulators, as an alternative to RCO requirements. Here too however, special consideration seems to be given to financial institutions, even if operating abroad. We submit that at least an equal level of recognition is appropriate for FERC approved and regulated System Operator functions. We further believe that it would be inappropriate and duplicative of FERC regulation, if a System Operator Market or the System Operator itself were to be deemed a CEA regulated “contract market” merely because it intermediated certain financial flows with respect to its own power system related transactions.

Exemption Upon Petition Procedures Are Necessary to Proper Flexibility

Irrespective of whether the automatic exemption criteria are modified, NYISO supports the inclusion of a provision permitting the Commission authority to grant individual petitions for Exempt MTEF status. Such a provision is now found at Section 36.2(h) of the Proposed Rules. This type of flexibility is, we believe, necessary to accommodate markets with which the Commission may not as yet be familiar as well as changing markets. However, NYISO urges the Commission to provide additional guidance in its rules as to the standards for granting such a petition. The Proposal is now silent on those standards. NYISO respectfully submits that Exempt MTEF status should be available based upon a petition showing that the market is resistant to price manipulation and its operation is unlikely to raise material customer protection issues. In this regard, NYISO also respectfully urges that the criteria should include consideration of the sufficiency of any other regulation applicable to the market in question, and to any special design or trader eligibility standards that may be applicable. NYISO further urges that, as to the petitions for relief from RCO status, the criteria focus upon the sufficiency of other applicable regulation.

In conclusion, NYISO credits the Proposal as an effort to modernize the Commission's approach to implementing the CEA. However, as explained above, it is in need of modification in order that System Operator Markets be permitted to operate and develop free from duplicative, unnecessary and potentially inappropriate Commission regulatory oversight. Thank you in advance for your consideration of these views.

Very truly yours,

A handwritten signature in black ink, appearing to read "W. J. Museler". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

William J. Museler
President & CEO

cc: Chairman William J. Rainer
Commissioner David D. Spears
Commissioner Barbara Pedersen Holum
Commissioner James E. Newsome
Commissioner Thomas J. Erickson