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October 21, 2009

COMMENT

David A. Stawick, Secretary  
Commodity Futures Trading Commission  
Three Lafayette Center  
1155 21st Street, NW  
Washington, DC 20581

VIA ELECTRONIC MAIL

Re: *Significant Price Discovery Contract Proceeding, Mid-C Financial Contracts*

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP submits the following comments in response to the request for public comment set forth in the Notice of Intent ("NOI") issued by the Commodity Futures Trading Commission ("CFTC" or "Commission") and published in the *Federal Register* on October 6, 2009,<sup>1</sup> addressing whether the following contracts offered for trading on the IntercontinentalExchange, Inc. ("ICE") perform a significant price discovery function:

- Mid-C Financial Peak ("MDC") contract;
- Mid-C Financial Peak Daily ("MPD") contract;
- Mid-C Financial Off-Peak ("OMC") contract; and
- Mid-C Financial Off-Peak Daily ("MXO") contract.<sup>2</sup>

The Working Group is a diverse group of commercial firms in the domestic energy industry whose primary business activity is the physical delivery of one or more energy

<sup>1</sup> *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), to Undertake a Determination Whether the Mid-C Financial Peak Contract; Mid-C Financial Peak Daily Contract; Mid-C Financial Off-Peak Contract; and Mid-C Financial Off-Peak Daily Contract, Offered for Trading on the IntercontinentalExchange, Inc., Perform Significant Price Discovery Functions*, 74 Fed. Reg. 51261 (Oct. 6, 2009).

<sup>2</sup> Collectively, these contracts are referred to hereinafter as the "Mid-C Contracts."

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commodities to customers, including industrial, commercial and residential consumers. Members of the Working Group consist of energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

As discussed further in these comments, the Working Group believes that none of the Mid-C Contracts serve a significant price discovery function and that the Commission might exceed its authority set forth in Section 2(h)(7) of the Commodity Exchange Act ("CEA"), 7 U.S.C. § 2(h)(7) (2008), if it determines that any of these contracts meet the criteria for designation as a significant price discovery contract ("SPDC").

#### **I. COMMISSION AUTHORITY AND DISCRETION TO DESIGNATE CONTRACTS AS SPDCS.**

In 2000, Congress enacted the Commodity Futures Modernization Act ("CFMA"),<sup>3</sup> which amended the CEA to create a tiered approach to the regulation of futures and derivatives markets to replace the CEA's then-existing "one size fits all" regulatory framework. As part of this tiered approach, the CFMA created exempt commercial markets ("ECMs"). ECMs are principal-to-principal electronic trading platforms designed to encourage electronic trading of derivatives by sophisticated market participants. ECMs were subject to limited Commission regulation and oversight under the CFMA amendments to the CEA.

In June 2008, Title XIII of the Food, Conservation and Energy Act of 2008<sup>4</sup> was enacted and, in relevant part, amended the CEA to include new Section 2(h)(7). CEA Section 2(h)(7) expanded the Commission's limited authority over ECMs to identify and list contracts that serve a significant price discovery function.<sup>5</sup> Specifically, this provision sets forth enumerated factors that the Commission must consider when determining whether a contract performs a significant price discovery function: (1) Price Linkage; (2) Arbitrage; (3) Material Price Reference; (4) Material Liquidity; and (5) Other Factors.

The purpose of new CEA Section 2(h)(7) is to make the regulation of certain contracts traded on ECMs similar to the Commission's regulation of those contracts traded on designated contract markets ("DCMs"). Accordingly, in situations where the Commission determines that ECM contracts serve a significant price discovery function similar to contracts traded on a DCM, those contracts are subject to comparable regulation.

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<sup>3</sup> Incorporated as Appendix E of the Consolidated Appropriations Act of 2001, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

<sup>4</sup> Title XIII of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1623 (June 18, 2008) (the "Reauthorization Act").

<sup>5</sup> Section 13204(c) of the Reauthorization Act requires the Commission to identify contracts that it deems appropriate for designation as SPDCs within 180 days after issuing rules implementing new CEA Section 2(h)(7).

On March 23, 2009, the Commission issued a final rule implementing the provisions of new CEA Section 2(h)(7) subjecting ECMs with SPDCs to self-regulatory and reporting requirements, as well as certain Commission oversight authorities, with respect to those contracts.<sup>6</sup> The SPDC Final Rule became effective on April 22, 2009. Among other things, the Commission adopted regulations establishing the procedures and the standards by which it will determine whether an ECM contract performs a significant price discovery function and provided guidance with respect to compliance with nine statutory core principles applicable to ECMs.<sup>7</sup>

The Commission has broad discretion when determining whether to designate a contract as a SPDC. Importantly, not all of the various statutory factors must be present to support a determination that a contract performs a significant price discovery function. In this regard, CEA Section 2(h)(7) neither prioritizes nor specifies the degree to which a contract must conform to the various factors.

The NOI represents the second instance in which the Commission has exercised its authority under CEA Section 2(h)(7) and Rule 36.3(c) to designate electricity contracts traded on an ECM as SPDCs. However, as noted further in Section II, below, it is the first time that the Commission has addressed the status of electricity contracts as SPDCs for a region where the underlying physical market is not an independently-administered, organized wholesale electricity market.

As discussed herein, despite the broad discretion provided the Commission to designate contracts traded on ECMs as SPDCs, the Working Group respectfully submits that such discretion should be used in a deliberate and limited manner so as not to impose overly broad and unnecessary restrictions and increased costs on legitimate market activity.

## **II. THE MID-C CONTRACTS AND THE UNDERLYING PHYSICAL WHOLESALE ELECTRICITY MARKETS.**

The Mid-C Contracts are financially-settled contracts based on the day-ahead index price published in the settlement month by ICE in the “ICE Day-Ahead Power Price Report.” Specifically, as described in the NOI:

- **MDC Contract.** The MDC contract is based on the arithmetic calendar-month average of peak-hour day-ahead electricity prices published daily in the “ICE Day-Ahead Power Price Report” for the Mid-Columbia Hub during all peak hours in the month of the electricity production. The peak-hour electricity price reported each day by the ICE is a

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<sup>6</sup> See *Significant Price Discovery Contracts on Exempt Commercial Markets*, 74 Fed. Reg. 12,178 (Mar. 23, 2009) (“SPDC Final Rule”); 17 C.F.R. § 36.3 (2009).

<sup>7</sup> *Id.* at § 36.3(c)(3).

volume-weighted index that includes qualifying, 5 day-ahead, peak hour power contracts based on the Mid-Columbia Hub that are traded on the ICE platform from 6 a.m. to 11 a.m. CST on the publication date.

- MDP Contract. The MDP contract is based on the day-ahead index price published in the settlement month by ICE for the specified day. The peak day-ahead electricity prices are published in the “ICE Day-Ahead Power Price Report.” For each peak day of the month, ICE reports a next-day peak electricity price for each hub.
- OMC Contract. The OMC contract is based on the arithmetic calendar month average of off-peak day-ahead electricity prices published in the “ICE Day-Ahead Power Price Report” for the Mid-Columbia hub during all off-peak hours in the month of the electricity production. The electricity price reported each day by the ICE is a volume-weighted index that includes qualifying day-ahead off-peak power contracts based on the Mid-Columbia Hub that are traded on the ICE platform from 6 a.m. to 11 a.m. CST on the date of publication. The ICE contracts on which the price index is based specify physical delivery of power.
- MXO Contract. The MXO contract is based on the day-ahead index price published in the settlement month by ICE for the specified day. The off-peak day-ahead electricity prices are published in the “ICE Day-Ahead Power Price Report.” For each off-peak day of the month, the ICE reports a next-day off-peak electricity price for each hub using the methodology noted above.

The Mid-Columbia region is a power trading hub for the Pacific Northwest comprising the control areas of three public utility districts (“PUDs”) in Washington that run hydroelectric projects on the Columbia River. The three PUDs are Grant, Douglas and Chelan. Hydro projects include Wells, Rocky Reach, Rock Island, Wanapum and Priest Rapids dams. In contrast to organized wholesale electric markets in California, New York, the Midwest, Mid-Atlantic and New England regions that are independently operated by regional transmission organizations/independent system operators approved by the Federal Energy Regulatory Commission (“FERC”), there is no formal market structure for the Mid-Columbia Hub or in the Pacific Northwest more generally. The electric grid comprising the Mid-Columbia Hub is operated by individual electric utilities and the wholesale physical energy market is primarily of a bilateral nature. All wholesale electricity transactions taking place in the Mid-Columbia Hub are subject to direct or indirect regulation and oversight by FERC.

### III. THE CFTC'S ANALYSIS OF THE CONTRACTS AS POTENTIAL SPDCs.

The NOI asserts that each of the Mid-C Contracts serves a significant price discovery function because each contract appears: (1) to serve as a Material Price Reference; and (2) to be Materially Liquid. In this context, it is important to note that Congress gave the Commission authority under CEA Section 2(h)(7) to capture contracts that trade with enough volume to (a) impact trading on a designated contract market, or (b) be quoted as an independent price reference by the public.<sup>8</sup> However, a closer examination of the Reauthorization Act and Section 36.3(c) of the Commission's regulations shows that the Mid-C Contracts do not satisfy either of these criteria and, therefore, do not serve a significant price discovery function.

#### A. Material Price Reference.

The first basis for the Commission's proposed determination that the Mid-C Contracts perform a significant price discovery function is that each contract serves as a Material Price Reference. CEA Section 2(h)(7)(B)(iii) requires the Commission to consider "the extent to which, on a frequent and recurring basis, bids, offers, or transactions in a commodity are directly based on, or are determined by referencing, the prices generated" by the ECM.<sup>9</sup> Guidance set forth in Appendix A to Section 36 of the Commission's regulations states that the Commission will rely on one of two sources of evidence, direct or indirect, that the contract is a Material Price Reference.<sup>10</sup> A direct reference would be whether the cash market quotes the ECM contract.<sup>11</sup> An indirect reference would be whether an industry publication quotes the ECM contract's price. The Mid-C Contracts meet neither of these standards.<sup>12</sup>

##### 1. Direct Reference.

There are no other related contracts traded in any market that settle to, or reference, the Mid-C Contracts. The only contract listed on a DCM or ECM other than ICE that references the Mid-Columbia Hub is the Dow Jones Mid-Columbia Electricity Index Futures ("NYMEX Mid-C Futures Contract") traded on the New York Mercantile Exchange. The NYMEX Mid-C Futures Contract settles on the "arithmetic average of all day-ahead Mid-

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<sup>8</sup> The Joint Explanatory Statement of the Committee of Agriculture Conference, H.R. Rep. No. 1110 627, 110 Cong., 2nd Sess. at 978-86 (2008).

<sup>9</sup> 7 U.S.C. § 2(h)(7)(B)(iii).

<sup>10</sup> 17 U.S.C. Part 36, Appendix A (2009) (Guidance on Significant Price Discovery Contracts).

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

Columbia electricity prices published by Dow Jones and Co. for peak hours in a contract month.”<sup>13</sup>

Based on the foregoing, the Material Price Reference in the Mid-Columbia Hub is the actual price for physical electricity, which is the purest reflection of supply and demand in that regional electricity market. The Mid-C Contracts, and any other contract in the market, whether bilateral, voice-brokered, or traded on a DCM, reference the prices for physical electricity for settlement purposes -- not the Mid-C Contracts. Accordingly, the Mid-C Contracts cannot and do not affect prices in the Mid-Columbia Hub.

## 2. Indirect Reference.

As to the indirect reference regarding whether an industry publication quotes the ECM contract’s price, the only publication to which the CFTC refers is the “ICE Day-Ahead Power Price Report,” an ICE publication. It is logical that ICE would publish the prices of its own contracts, as would any other contract market. However, the fact that ICE publishes the settlement prices of its own contracts does not constitute sufficient evidence of a Material Price Reference necessary to satisfy the requirements of CEA Section 2(h)(7)(B)(iii). As noted above, the only price reference that market participants use for trading in or around the Mid-Columbia Hub are the actual prices of physical electricity for that hub. The Commission does not provide any example of how even the forward price quotes for the Mid-C Contracts are used to price other transactions. No contract in any market is tied directly or indirectly to the settlement price of the Mid-C Contracts.

## B. Material Liquidity.

To meet the Material Liquidity test, CEA Section 2(h)(7)(B)(iv) requires that the contract traded on the ECM must trade with sufficient volume “to have a material effect on other agreements, contracts, or transactions listed for trading . . . on a designated contract market” or ECM.<sup>14</sup> The Commission also states “[l]iquidity is a broad concept that captures the ability to transact immediately with little or no price concession.”<sup>15</sup> As demonstrated below, the Mid-C Contracts lack both (a) a material effect on other contracts and (b) sufficient liquidity.

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<sup>13</sup> See <<[http://www.nymex.com/DO\\_desc.aspx](http://www.nymex.com/DO_desc.aspx)>>. The Dow Jones Mid-Columbia Electricity Price Indexes are volume-weighted averages of specifically defined *bilateral, wholesale, physical transactions*. Calculations for these indexes average power transactions from Columbia, Midway, Rocky Reach, Wells, and Wanapum/Vantage, delivery points along the Columbia River. Index participants provide Dow Jones with their itemized bilateral transactions and volume for eligible electricity products sold at the Mid-Columbia delivery points, as well as with any purchases made from entities not contributing to the indexes. See <<<http://www.djindexes.com/mdsidx/?event=energyUSDaily>>>.

<sup>14</sup> 7 U.S.C. § 2(h)(7)(B)(iv).

<sup>15</sup> 17 C.F.R. Part 36, Appendix A (2009).

1. No Material Effect on Other Contracts Listed for Trading.

Trading in the Mid-C Contracts has no affect whatsoever on any contract listed for trading on a DCM, ECM or even in the over-the-counter (“OTC”) market. All other Mid-C-related contracts (*i.e.*, those listed on DCMs or traded in the OTC market) settle directly to the physical electricity prices transacted in the Mid -Columbia Hub. Additionally, trading in the Mid-C Contracts has no affect whatsoever on the actual prices of physical electricity in that region and, as a consequence, there is no indirect affect on any other contracts listed for trading.

2. Liquidity in these Contracts is Insufficient.

Guidance set forth in Appendix A to Section 36 of the Commission’s regulations states, in relevant part, that “in markets where material liquidity exists, a more or less continuous stream of prices can be observed and the prices should be similar,” for example, to “a market where trades occur multiple times per minute.” The quoted language indicates two elements that can show liquidity: (a) a narrow bid/ask spread, and (b) a trade frequency of multiple trades per minute. Because neither factor is present in any of the Mid-C Contracts, trading in each of these contracts fails to meet this standard. At a minimum, prior to making any SPDC designations with regard to the Mid-C Contracts, the Working Group respectfully requests that the Commission undertake a quantitative analysis that considers whether such contracts are traded with the frequency required to meet the Commission’s Material Liquidity indicia.

IV. CONCLUSION.

Despite the Commission’s broad discretion to determine whether a contract performs a significant price discovery function, the Working Group respectfully submits that:

1. The Mid-C Contracts do not perform a significant price discovery function and should not be designated as SPDCs by the Commission.
2. The Mid-C Contracts do not meet the Material Price Reference or Material Liquidity standards set forth in CEA Section 2(h)(7).
3. Physical electricity prices in the Mid-Columbia Hub themselves provide the only material price reference for that market.
4. No other contract in any market is tied to the settlement price of the Mid-C Contracts and trading in the Mid-C Contracts has no affect whatsoever on physical electricity prices in the Mid-Columbia Hub.

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5. Because all other related Mid-C Contracts, regardless of whether they are traded on DCMs or in the OTC market, settle directly to physical electricity prices in the Mid-Columbia Hub, trading in the Mid-C Contracts has no affect on the prices of contracts in other markets.

The Working Group appreciates this opportunity to comment, and requests that the Commission consider these comments as it develops a final rule in this proceeding.

Respectfully Submitted,

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