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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

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C.F.T.C.
OFFICE OF THE SECRETARIAT

Re: *Significant Price Discovery Contract Proceeding, SP-15 & NP-15 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,[1] addressing whether the following contracts offered for trading on the IntercontinentalExchange, Inc. ("ICE") perform a significant price discovery function:

- SP-15 Financial Day-Ahead LMP Peak ("SPM") contract;
- SP-15 Financial Day-Ahead LMP Peak Daily ("SDP") contract;
- SP-15 Financial Day-Ahead LMP Off-Peak Daily ("SQP") contract;
- SP-15 Financial Swap Real Time LMP - Peak Daily ("SRP") contract;
- SP-15 Financial Day-Ahead LMP Off-Peak ("OFP") contract;

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[1] *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 SP-15 Financial Day-Ahead LMP Peak Contract; SP-15 Financial Day-Ahead LMP Peak Daily Contract; SP-15 Financial Day-Ahead LMP Off-Peak Daily Contract; SP-15 Financial Swap Real Time LMP-Peak Daily Contract; SP-15 Financial Day-Ahead LMP Off-Peak Contract; NP-15 Financial Day-Ahead LMP Peak Daily Contract; and NP-15 Financial Day-Ahead LMP Off-Peak Daily Contract, Offered for Trading on the IntercontinentalExchange, Inc., Perform Significant Price Discovery Functions*, 74 Fed. Reg. 51264 (Oct. 6, 2009).

- NP-15 Financial Day-Ahead LMP Peak Daily ("DPN") contract; and
- NP-15 Financial Day-Ahead LMP Off-Peak Daily ("UPN").[2]

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 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.

For the reasons discussed herein, the Working Group believes that none of the contracts designated above serve a significant price discovery function and the designation of such contracts as significant price discovery contracts ("SPDCs") might exceed the Commission's authority as set forth in Section 2(h)(7) of the Commodity Exchange Act ("CEA"), 7 U.S.C. § 2(h)(7) (2008), and Section 36.3(c) of its regulations, 17 C.F.R. § 36.3(c) (2009).

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

In 2000, Congress enacted the Commodity Futures Modernization Act ("CFMA"),[3] 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[4] 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.[5] Specifically, this provision sets forth

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2 Collectively, these contracts are referred to hereinafter as the "CAISO Contracts."

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

4 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").

5 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).

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"). The rationale for this statutory change is based on parity. 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.

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.[6] 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.[7]

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 contracts traded on an ECM as SPDCs. It is first time, however, that the Commission has addressed the status of an electricity contract as an SPDC.

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 CAISO CONTRACTS AND THE UNDERLYING PHYSICAL WHOLESALE ELECTRICITY MARKET.

The CAISO Contracts are financially-settled contracts traded on ICE that are based upon the volumetric weighted average of locational marginal prices ("LMPs") of physical

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6 *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).

7 *Id.* at § 36.3(c)(3).

electricity in the regional wholesale electricity market operated by the California Independent System Operator, Inc. ("CAISO").[8] The LMPs are derived from costs associated with energy, congestion and losses at different pricing points (or nodes) within the CAISO footprint.[9] The LMPs are posted by the CAISO on a Day-Ahead and Real-Time (*i.e.,* hour-by-hour) basis.

The CAISO Day-Ahead market is an essential part of the planning, modeling and scheduling required to ensure the reliable and secure operation of the CAISO electric grid. A critical element of the Day-Ahead market is the requirement that all scheduled flows of electricity must be balanced. Specifically, the day before expected delivery of physical electricity, the planned schedule for delivering electricity to load (*i.e.,* customers) in the CAISO footprint must be equal to the offers to supply electricity to the market.

The CAISO Real-Time market functions as a dynamic balancing market. Depending on the conditions affecting the real-time operation of the CAISO electric grid, generation scheduled for delivery to load is subject to curtailment to address, among other things, unanticipated drops in demand, conditions affecting the secure operation of the transmission system, or the loss of scheduled supply resources. Conversely, additional generation may have to be dispatched to meet unanticipated increases in demand. As a consequence, the cleared LMP for CAISO's Real-Time market reflects natural market forces of supply and demand for physical electricity at each pricing point for each hour of a given day.

The ICE swaps market does not, and cannot, influence the LMPs for physical electricity posted by the CAISO on a Real-Time and Day-Ahead basis. As noted above, the only factors that the CAISO takes into consideration when setting the LMP for these markets

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[8] The CAISO is a non-profit public benefit corporation that is responsible for the administration and operation of the majority of the State of California's high-voltage wholesale electric grid. The CAISO's operation of wholesale electricity markets within its footprint are subject to the exclusive jurisdiction of the Federal Energy Regulatory Commission ("FERC") under Part II of the Federal Power Act ("FPA"), 16 U.S.C. § 824 *et seq.* Market participants transacting into, within, or through the CAISO are subject to market rules designed by the CAISO that have been approved by, and are on file with, FERC.

[9] It is important to note that the physical electricity market reflects the unique nature of electricity as a non-storable commodity. Specifically, to ensure the reliable and secure operation of the electrical grid, generation supply must equal demand at all times. Significant technological expertise and complex modeling, planning and scheduling is required for each and every second of the day. The LMP, regardless of whether it is generated for the CAISO's Day-Ahead or Real-Time markets, is reflective of this vital balance of generation supply and demand.

In addition, the physical electricity markets administered by the CAISO recently underwent significant changes as part of the CAISO's Market Redesign and Technology Upgrade ("MRTU") efforts. *Cal. Indep. Sys. Operator Corp.*, 116 FERC ¶ 61,274 (2006), *order on reh'g*, 119 FERC ¶ 61,076 (2007), *order on reh'g and denying motion to reopen record*, 120 FERC ¶ 61,271 (2007) (approving the MRTU market design). As such, the data from the MRTU market in CAISO is evolving and maturing. Accordingly, based on this fact alone, the Working Group believes that it is premature for the Commission to consider making an SPDC determination for the CAISO Contracts.

is the available supply of physical electricity and the available demand for physical electricity. Any product traded outside of the CAISO's Day-Ahead and Real-Time physical markets does not have any impact whatsoever on the posted LMPs.

III. PROPOSED DESIGNATION OF CAISO CONTRACTS AS SPDCs.

The NOI asserts that each of the CAISO 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: (1) impact trading on a designated contract market, or (2) be quoted as an independent price reference by the public.[10] However, a closer examination of the Reauthorization Act and Section 36.3(c) of the Commission's regulations shows that the CAISO 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 CAISO 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.[11] In guidance set forth in Appendix A to Section 36 of the Commission's regulations, the Commission states that it will rely on one of two sources of evidence, direct or indirect, that the contract is a Material Price Reference.[12] A direct reference would be whether the cash market quotes the ECM contract.[13] An indirect reference would be whether an industry publication quotes the ECM contract's price. The CAISO Contracts meet neither of these standards.[14]

1. Direct Reference.

There are no other related contracts traded in any market that settle to, or reference, the CAISO Contracts. The Material Price Reference in the market is the actual CAISO LMPs for physical electricity, which is the purest reflection of supply and demand in the CAISO

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

11 7 U.S.C. § 2(h)(7)(B)(iii).

12 17 U.S.C. § 36, Appendix A (2009) (Guidance on Significant Price Discovery Contracts).

13 *Id.*

14 *Id.*

market. The CAISO Contracts, and any other contract in the market, whether bilateral, voice-brokered, or traded on a designated contract market, would reference the CAISO Day-Ahead and Real-Time LMP settlement prices. The CAISO Contracts cannot and do not affect prices in CAISO.

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 Commission refers is the "West Power End of Day Package," which is published by ICE. 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 to satisfy the requirements of CEA Section 2(h)(7)(B)(iii). The only price references that market participants use for trading in or around CAISO are the most reliable price references, which are the physical CAISO market Day-Ahead and Real-Time LMPs. The Commission does not provide any example of how even the forward price quotes for the CAISO Contracts are used to price other transactions. No contract in any market, whether physical or financial, is tied directly or indirectly to the settlement price of the CAISO 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.[15] The Commission also states "[l]iquidity is a broad concept that captures the ability to transact immediately with little or no price concession."[16] As demonstrated below, the CAISO Contracts lack both (a) a material effect on other contracts and (b) sufficient liquidity.

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

Trading in the CAISO 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 CAISO-related contracts (*i.e.,* listed on DCMs or traded in the OTC market) settle directly to physical CAISO Day-Ahead and Real-Time LMPs - not to CAISO Contracts. Additionally, trading in the CAISO Contracts has no affect whatsoever on the actual CAISO Day-Ahead and Real-Time LMPs and, therefore, there is no indirect affect on any other contracts listed for trading.

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15 7 U.S.C. § 2(h)(7)(B)(iv).

16 17 C.F.R. Part 36, Appendix A (2009).

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 CAISO 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 CAISO 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 CAISO Contracts do not perform a significant price discovery function and should not be designated as SPDCs by the Commission.

2. The CAISO Contracts do not meet the Material Price Reference or Material Liquidity standards set forth in CEA Section 2(h)(7).

3. CAISO Day-Ahead and Real-Time LMPs 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 CAISO Contracts and trading in the CAISO Contracts has no affect whatsoever on physical CAISO Day-Ahead and Real-Time LMPs.

5. Because all other CAISO-related contracts, regardless of whether they are traded on DCMs or in the OTC market, settle directly to the physical CAISO LMPs, trading in the CAISO 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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